Economic Sanctions Programs & Derivatives

Retrospective analysis of the impact of selected Sanctions Programs on Derivatives Markets from 2020-2023

International Swaps and Derivatives Association, Inc.

10 E 53rd Street
9th Floor
New York, NY 10022

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1. INTRODUCTION

In December 2019, ISDA published the white paper "*Economic Sanctions Programs & Derivatives - Issues for Derivatives Transactions and Principles for Minimizing Impact on Non-sanctioned Entities and Avoiding Market Disruption*" (the "**White Paper**").[1] The purpose of the White Paper was to inform market participants and regulators of the unique challenges that economic sanctions programs could present to over-the-counter ("**OTC**") derivatives markets. The White Paper drew from experience of sanctions programs implemented during the period from 2014 to 2019, including the US and EU Russia/Ukraine related sanctions programs introduced from 2014 and the US Venezuela sanctions programs introduced from 2017. The White Paper highlighted potential risks to derivatives markets if the use of economic sanctions were to be extended and set out recommended principles for regulators to consider in the enactment, oversight and enforcement of sanctions programs to minimize the impact of sanctions on non-sanctioned entities and avoid market disruption.

In December 2020, ISDA followed up on the White Paper by publishing the guidance note "*ISDA Guidance Note for Addressing Sanctions Issues in ISDA Documentation*" (the "**Guidance Note**") highlighting ways in which standardized ISDA documentation might be amended by market participants to address some of the potential challenges associated with economic sanctions programs that had been identified in the White Paper.[2]

Although there had been some notable consequences for derivatives from sanctions programs enacted prior to the publication of the White Paper and the Guidance Note (as discussed in those papers), the impact had been fairly limited. Although many of the issues raised in the White Paper were hypothetical, they concerned areas where ISDA believed all users of derivatives would benefit from coherent guidance on the application of existing sanctions programs and in respect of any future sanctions programs. Since 2020, there has been a significant increase in the use of economic sanctions in furtherance of foreign policy goals in the US, the EU, the UK and beyond. The expansion of existing sanctions programs (including the introduction of novel sanctions measures) has directly affected some major derivatives trading relationships and given rise to challenges in certain derivatives markets. While recent focus has understandably been on the unprecedented sanctions programs implemented across the globe in response to Russia's invasion and ongoing occupation of Ukrainian territory from February 2022, other measures such as the US Chinese Military Company Sanctions of 2020 and 2021 have also raised issues for derivatives users.

For the first time, financial institutions that are major users of OTC derivatives have become subject to full blocking sanctions in the United States and other jurisdictions. This necessitated the immediate cessation of numerous significant derivatives trading relationships and meant that obligations under existing transactions could not continue to be performed. Various

[1] *Available at* https://www.isda.org/2019/12/18/economic-sanctions-programs-derivatives/. ISDA has over 1000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers.

[2] *Available at* https://www.isda.org/2020/12/15/isda-guidance-note-for-addressing-sanctions-issues-in-isda-documentation/.

licenses were issued by sanctions authorities to address the unwinding of these existing positions (reflecting recommendations made in the White Paper to avoid significant market disruption).

There has also been an expansion in the use of sanctions measures which restrict origination and trading activities in relation to certain debt and equity instruments issued by targeted governments or companies. Some of these issuers and instruments have included components of major credit and equity indices. Users of derivatives that provide exposure to these issuers and instruments (or the indices which include them) have been impacted by these measures.

Some sanctions targets have also been cut off from accessing the international banking, payments, securities intermediaries and settlement systems, which has affected their ability to make scheduled payments and deliveries (or termination payments) under derivatives transactions. In some cases, these prohibitions have also affected the access of entities that are not themselves sanctioned but that rely on intermediaries that are sanctions targets.

In response to the considerable expansion of the use of economic sanctions, certain jurisdictions that have been impacted by those measures (or that anticipate being impacted by future sanctions programs) have introduced 'anti-foreign sanctions laws'. Such laws may include a range of different measures intended to block compliance with (and restrict enforcement of) foreign sanctions, protect domestic businesses and individuals from their effects and authorize the use of countermeasures against persons associated with the implementation or administration of those sanctions.

There have also been developments in the administration and enforcement of sanctions, notably the prominent role played by the UK's Office of Financial Sanctions Implementation ("**OFSI**") following the UK's departure from the European Union.

Throughout this period, as part of its mission to foster safe and efficient derivatives markets, ISDA has continued to actively and constructively engage with market participants and sanctions authorities in addressing the unique challenges that these economic sanctions programs present to derivatives markets. Where appropriate, ISDA has helped coordinate industry-wide solutions to promote certainty and market functioning via its various working groups and sub-committees. ISDA is committed to assisting its members' compliance with all sanctions programs promulgated by their respective regulators.

The purpose of this paper is to examine the impact that sanctions programs have had on derivatives transactions since the publication of the White Paper. Many of the experiences faced by market counterparties were of a similar nature to the concerns raised in the White Paper but some novel issues also arose. In some cases, sanctions programs were implemented in a manner that was broadly consistent with principles espoused by ISDA in the White Paper, which provided market counterparties with the opportunity to safely exit their positions. In other cases, additional action and guidance from sanctions authorities would have helped reduce uncertainty around the scope of the sanctions measures and the related relief and further reduce the potential adverse effects on non-sanctioned entities.

Increased tension in global trade and military activity will likely lead to further use of economic sanctions across many jurisdictions, which may include measures affecting large, internationally integrated economies with significant derivatives markets. By highlighting the experiences of the past few years and identifying areas of concern, this paper aims to build on the work in the White Paper to provide regulators with a broader understanding of the potential impact of current and future sanctions programs on derivatives markets. It is intended to help regulators design and implement future sanctions programs in a way that is compatible with existing market safety mechanisms, without compromising the efficacy of those programs in achieving desired foreign policy goals. This paper may also assist market participants in better understanding these issues that may arise and, in particular, how contractual provisions in their derivatives documentation may operate in the context of new sanctions programs.

ISDA intends to continue actively engaging with sanctions authorities and other regulators to articulate the challenges market participants face trading derivatives that are subsequently impacted by sanctions and the considerations that sanctions authorities should take into account, including (in appropriate circumstances) when issuing licenses and interpretive guidance.

Terminology and Structure

This paper is intended to be read in conjunction with the White Paper and the Guidance Note. For ease of reference, we use the same terminology in this paper as used in the White Paper. We refer to the imposition of economics sanctions as a "**sanctions program**" and any legal or regulatory body that imposes or administers a sanctions program as a "**sanctions authority**". Any entity that becomes the target of a sanctions program is referred to as a "**sanctioned entity**" and any other entity that is required to comply with a sanctions program as a "**non-sanctioned entity**". The glossary to the White Paper includes basic descriptions of some derivatives instruments as well as an explanation of some other commonly used terms in this paper. Other terms have the meanings given to them in the applicable ISDA standardized documentation.

Drawing upon the approach taken in the White Paper, this paper is split into three parts:

- Part 1 provides an overview of the principal sanctions programs that have impacted derivatives markets since 2020, as well as measures taken in certain jurisdictions in response to those sanctions.

- Part 2 considers the impact of these sanctions programs on derivatives transactions entered into by a non-sanctioned entity with a sanctioned entity, which we refer to as "**direct transactions**".

- Part 3 considers the impact of these sanctions programs on derivatives transactions entered into by two non-sanctioned entities, but which reference or give economic exposure to a sanctioned entity (or obligations or instruments of that sanctioned entity) or for which the underlying asset is otherwise impacted by sanctions, which we refer to as "**reference transactions**".

This paper includes some fictionalized examples to illustrate how some of the actual sanctions measures taken (and the associated licenses and interpretive guidance) have impacted derivatives market participants.

This document is intended as an information resource only; it does not contain legal advice and should not be considered a guide to or explanation of all relevant issues or considerations in connection with the potential impact of sanctions on derivatives transactions. You should consult your legal advisors and any other advisor you deem appropriate in considering the issues discussed herein. ISDA assumes no responsibility for any use to which any of these materials may be put.

2. PART 1: OVERVIEW OF RECENT SANCTIONS MEASURES AFFECTING DERIVATIVES MARKETS

2.1 Impact of sanctions on derivatives markets

The principal forms of sanctions measures that have affected derivatives markets since 2020 are set out below. Other sanctions measures such as restrictions on the provision of professional services and import and export controls may also impair parties' abilities to enforce their rights or perform their obligations under derivatives transactions, but consideration of these is outside of the scope of this paper. As discussed elsewhere in this paper, sanctions authorities apply different rules and this paper is not intended to provide a comprehensive summary of the application of the rules in each jurisdiction.

The breadth and novelty of sanctions programs, especially in recent years, makes it difficult to predict in advance what impact sanctions measures may have on derivatives trading relationships or on derivatives transactions in particular asset classes. Although both ISDA master agreements and definitional booklets published by ISDA are periodically updated, this is a significant exercise and does not generally happen more than once a decade. Even once these documents are updated, derivatives transactions governed by prior versions of ISDA master agreements, or that incorporate prior sets of definitions, may continue to be subject to the terms of those documents well beyond the date of such update. The potential for market-standard derivatives documentation to contemplate and effectively address the risks of unknown future sanctions measures (assuming that such risks can even be addressed in documentation) is therefore limited and sanctions-specific provisions have not generally been a feature of such documentation. In the absence of such market-standard provisions, negotiating the inclusion of bespoke sanctions provisions with a counterparty on the basis that at some point in the future it may become a sanctioned entity and/or transactions with that party may be affected by sanctions is challenging for several reasons. First, deviating from market-standard terms risks creating asymmetric positions (making hedges less effective). Moreover, assessing to which counterparties or jurisdictions such provisions should apply requires making difficult and sensitive predictions of future sanctions policies. Such provisions may breach local anti-foreign sanctions laws (as discussed further below).

2.2 Blocking sanctions / asset freezes

(a) *Overview*

Asset freezes (known as 'full blocking' sanctions in the US) are a foundational tool of sanctions programs and have been extensively used by sanctions authorities targeting individuals, companies and governmental entities as part of the various sanctions programs implemented in response to Russia's invasion of Ukraine. The US, the UK and the EU each maintain lists of sanctioned entities and individuals subject to these sanctions.

Assets freeze provisions in effect prohibit persons subject to their jurisdiction from dealing with sanctioned entities in virtually any way. Those prohibitions take effect in various ways, but the most common is that they create violations when a person deals in the assets of a sanctioned entity or any assets in which the target has an interest. Commonly, when a subject person comes into possession of the assets of a sanctions target, the person is obliged to 'freeze' the assets, rather than return them to the sanctions target. Additionally, in some jurisdictions, assets freeze provisions require certain bodies (generally in the financial services sector or other regulated sectors) to report known dealings with sanctions targets.

The US list is known as the 'specially designated nationals' ("**SDN**") list and is maintained by the US Treasury's Office of Foreign Assets Control ("**OFAC**"). The US applies the '50 percent rule' such that if one or more sanctioned persons directly or indirectly own 50 percent or more of a legal entity individually or in the aggregate, that entity will also be considered a sanctioned entity.[3] US persons are prohibited from dealing with an SDN and must block all assets of, and all transactions with, or involving, an SDN.

UK asset freeze sanctions apply to individuals and entities ('designated persons') on the consolidated list of asset freeze targets maintained by OFSI. The UK sanctions also apply to any entity that is determined to be 'owned or controlled directly or indirectly' by a designated person based on a number of tests set out in the legislation. The sanctions prohibit <u>dealing in funds or economic resources</u> (emphasis added) belonging to or owned, held or controlled by a designated person or <u>making funds or economic resources available</u> (emphasis added) to or for the benefit of a designated person.

The EU also maintains a consolidated financial sanctions list of all individuals, groups and entities subject to asset freezes and prohibitions on making funds and economic resources available to them.

Both the EU and UK[4] asset freeze sanctions extend to companies 'owned or controlled' by the entities listed. An entity satisfies the 'ownership' test when <u>over</u> 50 percent (rather than the 50 percent or more test in the US) of it is owned, directly or indirectly, by a person listed on their respective lists. Like the US, the EU applies an aggregate ownership test where two or more listed persons in aggregate own more than 50 percent.[5] In the UK, no aggregation applies unless the relevant shares or rights held are subject to a joint arrangement or one party controls the rights of another. Under the separate 'control' test, the EU and UK sanctions generally also apply to any entity 'controlled' by a person on their respective lists. Control involves a much less bright line and more fact-specific analysis than ownership and considers various factors that may be of relevance. The factors to be considered in determining control in the EU and UK are different, and in some cases information required to test for control may not be available.

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[3] Department of the Treasury, OFAC, *Revised Guidance on Entities Owned by Persons Whose Property and Interests in Property are Blocked*, Aug. 13, 2014, *available at* https://ofac.treasury.gov/media/6186/download?inline#:~:text=Persons%20whose%20property%20and%20interests%20in%20property%20are%20blocked%20pursuant,individually%20or%20in%20the%20aggregate%2C.

[4] HM Treasury, Office of Financial Sanctions Implementation, *General guidance for financial sanctions under the Sanctions and Anti-Money Laundering Act 2018*, August 2022, *available at* https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1173762/UK_Financial_Sanctions_General_Guidance.pdf.

[5] European Commission Directorate-General for Financial Stability, Financial Services and Capital Markets Union, *Consolidated version of the FAQs on sanctions against Russia and Belarus*, Publication date 31 October 2023 *available at* https://finance.ec.europa.eu/publications/consolidated-version_en

In addition to its asset freeze sanctions, the EU has introduced a prohibition on directly or indirectly engaging in any transactions with certain state-owned companies.[6] This prohibition not only extends to entities established outside the EU whose proprietary rights are directly or indirectly owned for more than 50% by such entities but also to entities 'acting on behalf or at the direction of' such entities. The EU Commission amended its FAQs in October 2023[7] to provide guidance to national competent authorities on the interpretation of this phrase, stating that they should 'take into account all the relevant circumstances' and in particular consider modifications in the ownership structure that may have been put in place in bad faith to camouflage the effective ownership or control and circumvent the prohibition.

In respect of the Russian sanctions, different governments have taken different approaches as to which entities and individuals they determine should be subject to asset freezes and other related measures and so each relevant sanctions authority's list is different. In addition, common sanctions targets have been added to the lists at different times. Assessing the full scope of each list is further complicated for market participants by the different tests of ownership and/or control (or acting on behalf/at the direction) applied by each sanctions authority outlined above.

In this paper, these types of sanctions are collectively referred to as "**blocking sanctions**".

(b) *Effect on Derivatives*

In the context of derivatives, the main consequence of these blocking sanctions has arisen in circumstances where counterparties to derivatives trading relationships (or their owners or controlling parties) have been added to one or more of the lists. Prior to 2022, entities subject to blocking sanctions did not generally have significant connections to the global financial markets and were not engaged in derivatives trading activities. However, in 2022, several of the largest Russian banks were added to the relevant list(s) maintained by one or more sanctions authorities. Part 2 of this paper considers the impact of these actions in detail.

As certain blocking sanctions (notably in the US) prevent trading in the securities of the sanctions target, they also impact derivatives that reference or provide economic exposure to these securities. Part 3 of this paper considers the effect of these blocking sanctions on certain reference transactions.

2.3 Sanctions affecting access to bank payments securities transfer systems

(a) *Overview*

The United States imposes correspondent and payable-through account ("**CAPTA**")

[6] *See* Council of the European Union, *Council Regulation (EU) 2022/428 of 15 March 2022, amending Regulation (EU) 833/2014*, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32022R0428 (Recital (6) and Article 1(9)).

[7] EU Commission, *State-Owned Enterprises Related Provision: Article 5aa of Council Regulation 833/2014, Frequently Asked Questions, as of 23 October 2023*, *available at* https://finance.ec.europa.eu/system/files/2023-10/faqs-sanctions-russia-state-owned-enterprises_en_0.pdf.

sanctions on foreign financial institutions determined to be subject to the CAPTA prohibitions.[8] As a result of these sanctions, US financial institutions are prohibited from (1) the opening or maintaining of a correspondent account or payable-through account for or on behalf of such institutions and (2) the processing of transactions involving these entities.

The equivalent UK regulations prohibit a UK credit or financial institution from establishing or continuing a correspondent banking relationship with (or from processing sterling payments to, from or via) a designated person (or a credit or financial institutions owned or controlled by a designated person).[9]

Although the EU does not have equivalent sanctions on correspondent banking relationships, it has introduced prohibitions on the acceptance of deposits of more than EUR100,000, the provision of services in respect of certain transferable securities by central securities depositories and the provision of crypto-asset wallet, account, or custody services, in each case to or from Russian nationals, residents, or operators established in Russia. In addition, on March 2, 2022, the EU issued a regulation prohibiting the provision of specialized financial messaging services (e.g., those provided by the Society for Worldwide Interbank Financial Telecommunication ("**SWIFT**")), which are used to exchange financial data, to ten Russian banks and four Belorussian banks (and entities in Russia directly or indirectly owned 50 percent or more by these banks). The widespread global use of the SWIFT payment messaging service outside of the US, EU and UK makes it difficult for banks outside those jurisdictions to facilitate transactions with the prohibited Russian banks.

In this paper, these types of sanctions are collectively referred to as "**payment/settlement sanctions**".

(b) *Effect on Derivatives*

The main impact of these payment/settlement sanctions on derivatives transactions has been to make it more difficult for certain counterparties (both sanctioned and non-sanctioned) to make and receive payments or deliveries of securities or other assets to fulfil their rights and obligations under those transactions. This has given rise to questions of potential default as well as the application of contractual provisions addressing force majeure/impossibility type events and arguments around potential frustration of contract.

2.4 Sanctions affecting the provision or trading of new debt and equity

(a) *Overview*

Targeted non-blocking sanctions designed to restrict sanctioned entities' access to

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8 Including through Department of the Treasury, OFAC, *Directive 2 under Executive Order 14024 of April 15, 2021, Blocking Property With Respect To Specified Harmful Foreign Activities of the Government of the Russian Federation*, February 24, 2022 *available at* https://ofac.treasury.gov/media/918471/download?inline.

9 Section 17A of *The Russia (Sanctions) (EU Exit) Regulations 2019*, *available at* https://www.legislation.gov.uk/uksi/2019/855/regulation/17A

financing were first introduced in 2014 as a significant element of the US and EU sanctions packages in response to the Russian annexation of Crimea. These sanctions were also used by the US in its Venezuela-related sanctions program introduced in 2017 to restrict US persons from providing new financing to the Venezuelan government and its nationalized oil industry. The extension of these type of sanctions was a core component of the US, EU and UK's Russia-related sanctions packages introduced in 2022.

In the United States, Directive 3 under E.O. 14024, "Prohibitions Related to New Debt and Equity of Certain Russia-related Entities"[10], prohibits transactions and dealings by US persons in new debt of longer than 14 days' maturity and new equity of certain Russian state-owned enterprises and entities that operate in the financial services sector of the Russian Federation economy. Entities that remain subject to these additional restrictions (and that were not subsequently designated as SDNs) as of the date of this paper include Gazprombank and Russian Agricultural Bank.[11]

In addition, Directive 1 under E.O. 14024 prohibited participation by US entities in the primary market for ruble- or non-ruble-denominated bonds issued by the Central Bank of the Russian Federation, the National Wealth Fund of the Russian Federation, or the Ministry of Finance of the Russian Federation, as well as the lending of funds to such institutions. In February 2022, Directive 1A extended the sovereign debt restrictions to cover participation in the secondary market for ruble- and non-ruble-denominated bonds issued after March 1, 2022 by these three institutions.[12]

In the EU and the UK, new loans and credit arrangements exceeding 30 days with many Russian banks are prohibited. In addition, there is a prohibition on dealing directly or indirectly in transferable securities and money market instruments (in most cases with a maturity of greater than 30 days). In the EU, it is prohibited to "directly or indirectly purchase, sell, provide investment services for or assistance in the issuance of, or otherwise deal with transferable securities and money market instruments issued after March 9, 2022 by Russia or the Central Bank of Russia (or entities acting on their behalf or at their direction). Similarly in the UK, it is prohibited for a person to deal directly or indirectly with a transferable security or money-market instrument which was issued after March 1, 2022 by the government of Russia.

In this paper, these types of sanctions are collectively referred to as "**new debt/equity sanctions**".

(b) *Effect on Derivatives*

As discussed in the White Paper, the original introduction of these limited sanctions

[10] Department of the Treasury, OFAC, *Directive 3 Under Executive Order 14024, Prohibitions Related to New Debt and Equity of Certain Russia-related Entities*, Feb. 24, 2022, *available at* https://ofac.treasury.gov/media/918476/download?inline.

[11] Department of the Treasury, OFAC, *Non-SDN Menu-Based Sanctions List (NS-MBS List)*, October 31, 2023, *available at* https://www.treasury.gov/ofac/downloads/mbs/mbslist.pdf.

[12] Department of the Treasury, OFAC, *Directive 1A Under Executive Order 14024, Prohibitions Related to Certain Sovereign Debt of the Russian Federation*, Feb. 22, 2022, *available at* https://ofac.treasury.gov/media/918731/download?inline.

caused considerable uncertainty in derivatives markets as to whether prohibitions on trading new debt and new equity would also extend to the trading and settlement of reference derivatives contracts which do not generally distinguish between debt or equity instruments issued prior to or after the imposition of the relevant sanctions. This was addressed in the context of the original sanctions packages (described in the White Paper) through a combination of regulatory interpretive guidance, general licenses and industry initiatives to exclude the relevant instruments from the scope of the derivatives. Part 3 of this paper considers the position further in respect of the latest sanctions packages.

2.5 Other sanctions affecting the trading of securities

(a) *Overview*

Since publication of the White Paper, a number of further novel sanctions programs have been introduced that affect the ability of non-sanctioned entities to deal in existing (rather than only new) securities issued by sanctions targets.

(i) CCMC/CMIC sanctions

In November 2020, US E.O. 13959[13] introduced a novel sanctions program, the Chinese Military Company Sanctions. E.O. 13959 which (1) prohibited US persons from the purchase for value of any publicly traded securities of designated 'Communist Chinese Military Companies' ("**CCMCs**"), as well as securities derivative of, or designed to provide investment exposure to, such securities, within 60 days of designation; and (2) provided US persons with authorization to divest any pre-existing interests within 365 days of designation. E.O. 13974 issued in January 2021, made amendments to E.O. 13959, including by clarifying that the prohibitions extended to sales of CCMC securities and that possessing targeted securities beyond the applicable divestment deadline would constitute a substantive violation of E.O. 13959.

In June 2021, President Biden rescinded E.O. 13974 and replaced E.O. 13959 with an amended version (E.O. 14032[14]) that made several changes including (a) replacing the CCMC list with a new list of China military industrial complex companies ("**CMICs**"); (b) narrowing the scope of the prohibition on derivative securities to only those that are 'publicly traded securities'; (c) harmonizing the definition of 'securities' with the definition in Section 3(a)(10) of the Securities Exchange Act and (d) not requiring US persons to divest their holdings of CMIC securities during the relevant 365-day divestment period set out in the original executive order.

In this paper, these sanctions are referred to as the "**CMIC sanctions**".

[13] Executive Order 13959 of November 12, 2020, Addressing the Threat From Securities Investments That Finance Communist Chinese Military Companies, 85 Fed. Reg. 73185 (November 12, 2020), *available at* https://www.federalregister.gov/documents/2020/11/17/2020-25459/addressing-the-threat-from-securities-investments-that-finance-communist-chinese-military-companies.

[14] Executive Order 14032 of June 3, 2021, Addressing the Threat from Securities Investments That Finance Certain Companies of the People's Republic of China, 86 Fed. Reg. 30145 (June 7, 2021), *available at* https://ofac.treasury.gov/media/99111/download?inline.

(ii) Russia 'new investment' sanctions

US executive order E.O. 14066 of March 8, 2022[15] prohibited 'new investment' in the Russian energy sector by US persons. E.O. 14068 of March 11, 2022[16] extended the prohibition to new investment in any sector of the Russian economy determined by the US Secretary of the Treasury and US executive order E.O.14071 of April 6 2022[17] further extended the prohibition to any new investment in the Russian Federation.

Subsequent guidance from OFAC[18] interpreted the term 'new investment' to include the 'commitment of capital or other assets for the purpose of generating returns or appreciation… made on or after the effective date' of the respective prohibitions (including investments resulting from the exercise of rights under pre-existing agreements occurring on or after the effective date of the respective prohibitions). OFAC further explained[19] that 'new investment' (among other things) includes purchase of new and existing debt and equity securities issued by an entity in Russia (emphasis added). However, 'new investment' does not include purchase of shares in a US fund containing debt or equity securities issued by entities in Russia, provided such holdings represent less than a predominant share by value of the fund. The term 'predominant share' had been used in previous OFAC interpretive guidance[20] but no further definition of the meaning of this term has been forthcoming. OFAC subsequently revised this guidance to remove any reference to the concept of predominance and replaced it with a standard of 50 percent or more share by value of the fund. Wind-down or divestment (including facilitation of such activity) of a pre-existing investment in Russia was also permitted.[21]

In this paper, these sanctions are referred to as the "**Russia new investment sanctions**".

(b) *Effect on Derivatives*

(i) CMIC sanctions

The CMIC sanctions may impact derivatives directly to the extent those derivatives constitute 'publicly traded securities derivative of' relevant securities of CMICs. US persons may not buy or sell these derivatives. These CMIC sanctions may also impact the ability of parties to hedge their obligations under derivatives that reference

15 Executive Order 14066 of March 8, 2022, Prohibiting Certain Imports and New Investments With Respect to Continued Russian Federation Efforts To Undermine the Sovereignty and Territorial Integrity of Ukraine, 87 Fed. Reg. 13625 (March 10, 2022), *available at* https://ofac.treasury.gov/media/919111/download?inline.

16 Executive Order 14068 of March 11, 2022 Prohibiting Certain Imports, Exports, and New Investment With Respect to Continued Russian Federation Aggression, 87 Fed. Reg. 14381 (March 11, 2022), *available at* https://ofac.treasury.gov/media/919281/download?inline.

17 Executive Order 14071 of April 6, 2022 Prohibiting New Investment in and Certain Services to the Russian Federation in Response to Continued Russian Federation Aggression, 87 Fed. Reg. 20999 (April 8, 2022), *available at* https://ofac.treasury.gov/media/922081/download?inline.

18 Department of the Treasury, OFAC, FAQ 1049, *available at* https://ofac.treasury.gov/faqs/1049.

19 Department of the Treasury, OFAC, FAQ 1054, *available at* https://ofac.treasury.gov/faqs/1054.

20 *E.g.*, Department of the Treasury, OFAC, FAQ 653, *available at* https://ofac.treasury.gov/faqs/653.

21 *See* updates to FAQ 1054 and FAQ 1055 on January 17, 2023, *available at* https://ofac.treasury.gov/faqs/1054 and https://ofac.treasury.gov/faqs/1055.

securities of CMICs but that have not been divested. These may include equity derivatives written specifically on those securities or equity derivatives written on baskets or indices (or baskets of indices) of which one or more securities of CMICs are a constituent. The impairment of a party's ability to hedge its position in an equity derivative transaction can trigger certain unwind provisions that can result in the termination of the relevant transaction and costs imposed on the other party. Part 3 of this paper considers the impact on such transactions in more detail.

(ii) Russia new investment sanctions

The Russia new investment sanctions provide another example of prohibitions on secondary market trading activity that apply to both new and existing securities. As US persons are prevented from purchasing Russian securities, this presents challenges for settling reference transactions that reference such securities or the issuers of those securities. Any physical settlement by a US person may be prevented by the inability of that person to acquire the securities while a cash settlement mechanism which relies on seeking bids for the securities may be affected by the inability of dealers that are required to abide by US sanctions. Part 3 of this paper explores these issues in the context of the settlement of credit derivative transactions on Russia in 2022.

2.6 Freezing of international reserves

(a) *Overview*

On February 28, 2022, OFAC issued Directive 4 under E.O. 14024, "Prohibitions Related to Transactions Involving the Central Bank of the Russian Federation, the National Wealth Fund of the Russian Federation, and the Ministry of Finance of the Russian Federation."[22] Pursuant to this Directive, US persons are prohibited from engaging in "any transaction" involving the Central Bank of the Russian Federation, the National Wealth Fund of the Russian Federation, or the Ministry of Finance of the Russian Federation.

The UK regulations prohibit a UK individual or entity from providing 'financial services for the purpose of foreign exchange reserve and asset management' to these entities. The EU regulations prohibit transactions related to the management of reserves or assets of Central Bank of Russia, including transactions with persons acting on its behalf, or at its direction, such as the National Wealth Fund.

In this paper, these types of sanctions are collectively referred to as "**foreign reserve sanctions**".

(b) *Effect on Derivatives*

Derivatives are used by central banks and sovereigns to manage their reserves and any such derivatives would constitute 'transactions' or 'financial services' relating to the

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22 Department of the Treasury, OFAC, *Directive 4 (As Amended) Under Executive Order 14024, Prohibitions Related to Transactions Involving the Central Bank of the Russian Federation, the National Wealth Fund of the Russian Federation, and the Ministry of Finance of the Russian Federation*, May 19, 2023, *available at* https://ofac.treasury.gov/media/918806/download?inline.

management of the relevant entities' reserves, assets or foreign exchange positions. Counterparties to these derivatives therefore must determine whether the effect of these provisions is substantially similar to the blocking sanctions and take action accordingly.

2.7 Anti-foreign sanctions laws and blocking laws

(a) *Overview*

In response to the considerable expansion of the use of economic sanctions, certain jurisdictions that have been impacted (or that anticipate being impacted by future sanctions) have introduced a series of laws collectively described as 'anti-foreign sanctions laws'. Such laws may include a range of different measures intended to block compliance with (and restrict enforcement of) foreign sanctions, protect domestic businesses and individuals from their effects and authorize the use of countermeasures against persons associated with the implementation or administration of those sanctions.

Following the imposition of sanctions by the US, the EU and the UK and a number of other countries, the Russian government enacted a number of such measures. Notably, Russia decree No. 252, "On Application of Retaliatory Special Economic Measures in Connection with Unfriendly Actions of Certain Foreign States and International Organizations"[23] introduced the following blocking measures in respect of certain 'designated persons' comprising individuals and entities of countries which imposed sanctions on Russia (referred to as 'unfriendly states' (including the US, the EU, the UK and around 20 other jurisdictions) prohibiting:

- Executing transactions (including foreign trade contracts) with a designated person;
- Performing outstanding obligations under existing transactions with a designated person;
- Conducting financial operations benefiting a designated person; and
- Exporting goods and/or raw materials produced and/or originated in Russia and supplied by or for the benefit of a designated person

Additional measures included certain restrictions on lending to foreigners in foreign currency, making foreign currency deposits or making transfers to foreign banks and prohibiting transactions with foreigners affiliated with 'unfriendly states' without a government permit which involve lending in rubles, transfer of ownership of certain securities and real estate and export of foreign currency.

In response to restrictions on Russian borrowers' access to foreign clearinghouses such as Euroclear, Russia also enacted regulations that allowed Russian borrowers to settle debts in Russia by issuing replacement local bonds and to make payments to foreign holders into restricted ruble accounts.[24] Similarly, payments to holders of Russia's

23 Decree of the President of May 3, 2022, No. 252, as amended, Resolution of the Government of the Russian Federation dated May 11, 2022, No. 851, as amended.

24 Decree of the President of the Russian Federation dated June 22, 2022, No. 394 and Order of the Ministry of Finance dated June 22, 2022, No. 240, as amended.

sovereign Eurobonds that relied on foreign infrastructure (where Russian accounts were frozen) were made to special ruble accounts with investors required to prove their title in those bonds to the National Settlement Depository before payments would be made into accounts with Russian banks.

In 2020 and 2021, China enacted new policy tools in response to the threat of foreign sanctions. These comprise an 'unreliable entity list', a 'blocking statute' and an 'anti-foreign sanctions law'.

Under the unreliable entity list measures, a foreign person or company that is designated by the Chinese authorities as 'unreliable' (i.e., endangering national security or development interests of China or applying discriminatory measures against a Chinese entity) may be subject to trade and investment restrictions and fines.

The blocking statute is primarily intended to address the threat of secondary sanctions (i.e., the negative impact on Chinese subjects of foreign sanctions measures that are designed to prevent them from trading with third-country entities). It provides a framework under which Chinese subjects are obliged to report circumstances where they are prohibited or restricted by foreign legislation or other measures from engaging in normal economic, trade and related activities with a third country or subjects of a third country. The Chinese authorities may issue injunctions requiring Chinese persons not to recognize, enforce or comply with any specific foreign law or measure which the government has designated based on a determination that it "unjustifiably prohibits or restricts the citizens, legal persons or other organisations of China from engaging in normal economic, trade and related activities with a third State (or region) or its citizens, legal persons or other organisations." The law also provides that where a person complies with the foreign laws and other measures within the scope of the injunction, and infringes the legitimate rights and interests of a Chinese subject, that Chinese subject can bring a compensation claim in a Chinese court against that person.

Unlike the blocking statue which appears to target the effects of secondary sanctions, the anti-foreign sanctions law is principally focused on responding to sanctions imposed on China and Chinese organizations and individuals. The law authorizes Chinese authorities to take action against persons (which may extend to related organizations and family members) that directly or indirectly participate in the development, decision-making, or implementation of foreign sanctions considered discriminatory against any Chinese citizen or organization. Such actions may include travel bans, freezing of assets in China, prohibition from doing business in China and other unspecified measures. In addition, the law prohibits organizations and individuals from helping enforce foreign discriminatory measures against Chinese entities, and (similar to the blocking statute) grants Chinese subjects the rights to judicial remedies for having to comply with foreign sanctions.

In this paper, these types of measures are collectively referred to as "**anti-foreign sanctions laws**".

(b) *Effect on Derivatives*

Anti-foreign sanctions laws can give rise to conflicting obligations on organizations that operate in, or are otherwise subject to laws in, multiple jurisdictions including where subsidiaries or affiliates are incorporated in jurisdictions that have enacted such anti-foreign sanctions laws.

In some cases, these conflicts could potentially lead to 'double jeopardy' situations where an organization is unable to comply with both sets of laws. For example, the White Paper identified the potential conflict for EU persons arising from Article 5 of the EU Blocking Regulation which prohibits EU persons from complying with certain US sanctions targeting Iran and Cuba. The White Paper noted that challenges in compliance with conflicting sanctions regimes and approaches are not unique to derivatives but highlighted that they may be particularly acute in the derivatives market owing to the multiple jurisdictions' laws that may be relevant in any trading relationship, as well as the requirements or regulatory expectation that the largest global financial institutions adopt global standards consistent with the laws of their home regulators.

The introduction of new blocking laws and other anti-foreign sanctions laws, including the measures recently introduced in Russia and China, create additional challenges in the context of derivatives transactions beyond the difficulties in complying with conflicting laws. In particular, if a party to an ISDA Master Agreement becomes a sanctions target but anti-foreign sanctions laws are introduced in its home jurisdiction that make it illegal for a sanctions target to perform its obligations (as was the case under the Russia measures) then that may affect the application of the contractual close-out mechanisms available to the parties. Part 2 of this paper considers the effect of such circumstances.

In addition, global financial institutions manage their derivatives exposures utilizing back-to-back intergroup transactions between affiliates. If such an institution's headquarters is required to comply with sanctions but its affiliate is subject to anti-foreign sanctions laws restricting such compliance then the ability to maintain these intragroup transactions may be impacted, affecting that institution's ability to effectively hedge its positions.

As of the date of this paper, there have been too few specific examples of the use of the new Chinese measures to be able to understand their full scope and potential implications, including in the context of derivatives transactions. Therefore, a detailed consideration of these is outside the scope of this paper. However, it is worth highlighting the potential for these, or similar laws that may be enacted in other jurisdictions, to create additional challenges.

By way of example, if OFAC were to determine that a Chinese bank was trading with US SDNs then it may decide to impose secondary sanctions in respect of the Chinese bank, e.g., restricting its access to US financial markets or designating the Chinese bank as an SDN. The Chinese authorities may then determine under the Chinese blocking law that those secondary sanctions unjustifiably prohibit the Chinese bank from engaging in normal economic, trade and related activities and issue an injunction against those US secondary sanctions measures. That may leave any derivatives counterparty transacting with the Chinese bank in a difficult position of either having to continue to trade with that Chinese bank (and risk being subject to US sanctions themselves) or to cease trading and close out its existing positions (and risk being sued for damages by the Chinese bank in a Chinese court). Even if it wished to close out, it may not have any contractual entitlement to do if it not directly subject to the jurisdiction of US laws and therefore its continued performance is not unlawful (see the discussion in Part 2 below) so may have to rely on the Chinese bank agreeing to do so.

Historically, use of secondary sanctions has been most prevalent in the context of US sanctions programs in Iran and North Korea (accounting for around 90% of all secondary sanctions designations). As these jurisdictions are not integrated into the global financial system, the impact on derivatives markets of these secondary sanctions is negligible. However, in light of the potential for increased use of secondary sanctions (and countermeasures against such secondary sanctions), market participants would welcome guidance on the extent to which derivatives trading may fall within the scope of activity that may be targeted by secondary sanctions.

3. PART 2: EFFECT OF SANCTIONS ON DIRECT TRANSACTIONS

3.1 Overview

As described in the White Paper, virtually all uncleared derivatives are governed by one of the standard form ISDA Master Agreement documents published by ISDA. The ISDA Master Agreement governs the trading relationship between two parties, typically a dealer and an end user or two dealers.

Recent sanctions actions have impacted the relationship between non-sanctioned entities and counterparties that have become sanctioned entities under ISDA Master Agreements.

3.2 Performance of obligations

Sanctions have affected the ability of both sanctioned entities and non-sanctioned entities to continue to perform their obligations under existing transactions. In particular, blocking sanctions require the immediate cessation of business with the relevant sanctioned entity absent a license or other permission from the relevant sanctions authority. Non-sanctioned entities with ISDA Master Agreements with counterparties that have become subject to blocking sanctions have generally interpreted such sanctions as preventing them from entering any new derivatives transactions, but also from making any further payments or deliveries under existing derivatives transactions despite their contractual obligations to do so under the relevant ISDA Master Agreement.

The ability for parties to perform their obligations in respect of existing transactions under ISDA Master Agreements has also been impacted by other sanctions measures, even where the counterparty is not subject to full blocking sanctions. These situations include where payment/settlement sanctions have prevented access to bank mechanisms required to make payments, settlement systems required to transfer securities or where export controls prevent a party making deliveries of certain commodities.

Each party's obligation to make payments or deliveries under transactions subject to an ISDA Master Agreement is subject to the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing (and that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated).[25] A 'Potential Event of Default' is any event which, with the giving of notice or the lapse of time or both, would constitute an Event of Default.

Under the ISDA Master Agreement, the failure by a party to make when due any payment or delivery under any outstanding transaction after notice of such failure and the expiration of the relevant grace period will constitute an 'Event of Default' in respect of that party.[26] The standard forms of the ISDA Master Agreement also include

[25] Section 2(a)(iii) of each ISDA Master Agreement.

[26] Such grace period one 'Local Business Day' or 'Local Delivery Day' (as applicable) under the 2002 ISDA Master Agreement or three 'Local Business Days' under the 1992 ISDA Master Agreement.

a 'Termination Event' (which is distinct from an Event of Default) for 'Illegality'[27] which arises if it becomes "unlawful under any applicable law" for one or both of the parties to make or receive a payment or perform their obligations with respect to any transactions under the ISDA Master Agreement or any credit support document.

Where the imposition of sanctions results in a situation where the non-sanctioned entity determines that it is prohibited from performing its obligations due to the relevant sanctions and therefore does not make a payment (or a transfer of margin) when it would otherwise be contractually required, its counterparty may conclude that a Potential Event of Default has arisen in respect of the non-sanctioned entity. On that basis, the sanctioned entity may determine that it is not required to make any payments or deliveries (including transfers of any margin) to that non-sanctioned entity while that Potential Event of Default remains outstanding. If it makes such a determination and ceases to make any further payments or margin transfers, the imposition of blocking sanctions (or other sanctions that impact a non-sanctioned entity's ability to perform) can lead to an immediate credit risk exposure of the non-sanctioned entity to the sanctioned entity.

However, the ISDA Master Agreement contains an override provision which provides (in the case of the 2002 ISDA Master Agreement) that an event or circumstance that "constitutes or gives rise to" an Illegality or a Force Majeure Event will not, for so long as that is the case, also constitute or give rise to a payment default "insofar as such event or circumstance relates to the failure to make any payment or delivery."[28] The corresponding provision in the 1992 ISDA Master Agreement is somewhat broader, providing that if an event or circumstance which would otherwise constitute or give rise to an Event of Default also constitutes an Illegality, it will be treated as an Illegality and will not constitute an Event of Default."[29]

Therefore, technically as failure by the non-sanctioned entity to make the payment arises because the non-sanctioned entity is prohibited from performing because doing so would be illegal due to the sanctions (an Illegality Termination Event), the override provision would apply and the failure to make the payment would not give rise to a Failure to Pay Event of Default (nor a Potential Event of Default that would permit the sanctioned entity to rely on the condition precedent discussed above).[30] However, in practice, it is unlikely that a sanctioned entity will continue to make payments to a counterparty which is no longer performing its obligations (and the sanctioned entity may indeed be prevented from doing so by authorities in its own jurisdiction) and may instead treat any such non-performance as a Potential Event of Default until the situation is more clearly understood.

In circumstances where a party is not receiving payments or deliveries (including margin) under derivatives transactions, it will typically wish to terminate those transactions as swiftly as possible to avoid increasing both its credit risk to its

27 Section 5(b)(i) of each ISDA Master Agreement.

28 Section 5(c)(i) of the 2002 ISDA Master Agreement.

29 Section 5(c) of the 1992 ISDA Master Agreement.

30 Although it is not uncommon for the provision of Section 2(a)(iii) to be amended such that the condition precedent also extends to Termination Events.

counterparty and its market risk from no longer having an effective hedge for the relevant positions that the derivatives transactions were intended to hedge.

3.3 Termination

In addition to the 'Failure to Pay' Event of Default and 'Illegality' Termination Event discussed above, the 2002 ISDA Master Agreement (but not the earlier 1992 version) includes a Termination Event for a 'Force Majeure Event' which applies where, after giving effect to any other applicable provision, fallback or remedy in the agreement, a party (or its credit support provider) is prevented from making or receiving payments or deliveries or complying with other material obligations (or it is impossible or impracticable to do so) "by reason of force majeure or act of state" that is beyond the control of the party and cannot be overcome using all reasonable efforts. The requirements for a Force Majeure Event are fact-specific and relatively untested. Although the possibility of a Force Majeure Event arising from the imposition of sanctions cannot be ruled out, it is unlikely to be available in all cases where parties' trading relationship may be impacted by sanctions.

Parties may also elect to include bespoke 'Additional Termination Events' in their ISDA Master Agreements.[31] At the time of publication of this paper, the inclusion of a specific 'Additional Termination Event' in ISDA Master Agreements relating to the imposition of sanctions is relatively uncommon, given that the prospect of economic sanctions impacting derivatives counterparties and the possible impact of "anti-foreign sanctions" laws are comparatively recent phenomena. However, recently there has been an increased focus on the inclusion of a sanctions termination event provision that is drafted to facilitate an orderly unwinding or divestment of transactions impacted by sanctions in a manner that balances the interests of the parties.

The occurrence of any 'Event of Default' or 'Termination Event' under the ISDA Master Agreement gives rise to a right to terminate outstanding transactions.[32] However, assuming the relevant sanctions permit termination, it is important to establish which is the relevant contractual basis for termination because this will determine:

- Which party is entitled to exercise the right to terminate the transactions by designating an 'Early Termination Date';
- What further conditions must be satisfied before that party can exercise that right;
- Which transactions may be terminated; and
- Which party determines the value of the terminated transactions and the payments that are due between the parties following termination to reflect that value.

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[31] The Guidance Note contains an example of such a provision that was proposed prior to the implementation of recent sanctions measures.

[32] All transactions in the case of an Event of Default and 'Affected Transactions' (i.e., all Transactions affected by the occurrence of such Termination Event) in the case of a Termination Event.

The table below summarizes the position with respect to each of these termination scenarios under the standard versions of the ISDA Master Agreement.

Event of Default/ Termination Event	**Which party is the Defaulting Party / Affected Party**	**Which party can terminate?**	**Conditions to Right to Terminate**	**Which Transactions may be terminated?**	**Which party determines the payments on termination**
Failure to Pay or Deliver	Party that failed to make payment	Non-defaulting party	Notice of default and expiry of grace period[33]	All Transactions	Non-defaulting Party
Illegality (1992 ISDA)	Party for which it is unlawful to pay /receive/ perform	Either party	Attempt to transfer to another Office/ Affiliate for up to 30 days[34]	All Affected Transactions	Non-affected Party (or both parties if two Affected Parties)
Illegality (2002 ISDA)	Party for which it is unlawful to pay /receive/ perform	Either party	3 Business Day Waiting Period	Any of the Affected Transactions	Non-affected Party (or both parties if two Affected Parties)
Force Majeure Event (2002 ISDA)	Party prevented from paying/ receiving / complying	Either Party	8 Business Day Waiting Period	Any of the Affected Transactions	Non-affected Party (or both parties if two Affected Parties)
Additional Termination Event	As specified in the relevant provision	Non-affected Party (either party if two Affected Parties)	None	All Affected Transactions	Non-affected Party (or both parties if two Affected Parties)

The recent experience of the Russia sanctions has highlighted many of the potential pitfalls of this contractual termination framework where a counterparty to an ISDA Master Agreement with outstanding transactions becomes a sanctioned entity.

To illustrate these problems, consider the following example (which is fictional but based on the experiences of some market counterparties when certain Russian banks became subject to immediate blocking sanctions in 2022).

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[33] One Local Business Day under the 2002 ISDA Master Agreement and three Local Business Days under the 1992 ISDA Master Agreement.

[34] Under Section 6(b)(ii) of the 1992 ISDA Master Agreement, if an Illegality occurs and there is one Affected Party, the Affected Party must use all reasonable efforts (which will not require it to incur a loss more than immaterial, incidental expenses) to transfer within 20 days after it gives notice under Section 6(b)(i) all of its rights and obligations in respect of the Affected Transactions to another of its Offices or Affiliates so that the relevant Termination Event ceases. If the Affected Party is not able to make such transfer, it will give notice to the other party within the 20-day period and the other party may effect the transfer within 30 days after the notice under Section 6(b)(i) was given. Any transfers are subject to the prior written consent of the remaining party, which will not be withheld if its policies would permit it to enter into transactions with the transferee on the terms proposed.

Example 1(A):

*Bank USA ("**BUSA**") is a global dealer bank incorporated in the United States with branches and subsidiaries in many of the world's major financial centers. National Bank of Ruritania ("**NBR**") is one of the largest national commercial banks in Ruritania, principally serving Ruritania's large energy sector.*

*NBR had entered into a series of currency swap transactions with BUSA to enable its energy sector clients to convert their foreign currency earnings in US dollars into the domestic currency, Ruritanian dollars ("**R$**"). Under these currency swaps BUSA is obliged to make periodic payments of R$ in exchange for NBR making equivalent payments of US$. The notional value of the transactions is US$10,000,000,000 and they were fixed at an exchange rate of R$100 per US$1. They were entered into under a 2002 ISDA Master Agreement, which included a Credit Support Annex under which NBR and BUSA had to make daily transfers of variation margin to reflect the mark-to-market value of the transactions. BUSA also fully hedged its FX market risk by entering into hedge transactions with other counterparties.*

On March 1, in response to Ruritania's hostile actions towards a neighboring country, NBR (along with several other Ruritanian banks) was placed on the United States SDN list with immediate effect. On March 2, under the transactions NBR was due to make a payment of US$1,000,000,000 in exchange for payment by BUSA of R$100,000,000,000. In response to the imposition of the sanctions, the Ruritanian dollar has depreciated by 20% and one US dollar is now worth R$120. Consequently, BUSA's mark-to-market exposure to NBR under the transactions is approximately US$2,000,000,000.

Under the US SDN regime (and equivalent blocking sanctions in other jurisdictions), US persons are prohibited from doing business with entities on the SDN list without a license. In the example, BUSA determines that it is prohibited from making the payment due on March 2. In addition, BUSA determines that it is prohibited from making a margin call under the Credit Support Annex in respect of its mark-to-market exposure. As a result of NBR being placed on the SDN list, BUSA's credit exposure to NBR (which had previously been fully margined) has increased by US$2 billion and because BUSA cannot make the payment due, it also faces the prospect of NBR not making the corresponding payment of US$1 billion. Although BUSA believes that the sanctions may give rise to an Illegality Termination Event under the ISDA Master Agreement, BUSA determines that exercising a right to terminate the outstanding positions without a license may constitute a breach of the sanctions. BUSA is now in the position that it has a significant credit and market exposure and is unable to mitigate its position. Any further currency depreciation will increase that exposure and, in a worst-case scenario, BUSA faces an exposure of up to the full US$10,000,000,000 notional value of the transactions. As a result of the sanctions, derivatives positions that were fully collateralized and hedged have immediately become unquantifiable, open-ended and unhedged.

Example 1(B):

As BUSA does not make the payment due on March 2, NBR sends BUSA a notice of failure to pay stating that if BUSA does not make payment on the next business day that NBR will designate an Early Termination Date with respect to all outstanding Transactions.

BUSA is now faced with the prospect of NBR terminating the outstanding transactions for a failure to pay event of default, potentially triggering cross-default provisions in other agreements. BUSA can claim that because it is prevented from making the payment by the sanctions then the Illegality override in the ISDA Master Agreement would apply. This would give rise to the three-day Waiting Period. However, at the end of that period, NBR would still have the right to designate an Early Termination Date and, as the 'Non-affected Party', NBR would still be responsible for determining the value of the terminated transactions.

Although termination of the transactions would effectively crystallize BUSA's exposure to NBR (meaning its positions are no longer open-ended), the methodology for making that determination in the ISDA Master Agreement requires NBR (as the sole 'Determining Party') to determine the value based on quotations that are available to NBR to replace the transactions.[35] The impact of the sanctions is likely to have had a material impact on NBR's ability to access replacement transactions and consequently the pricing available to it may be significantly worse than would be available to BUSA and that cost will be passed on to BUSA in the determination of the amount due.

As illustrated by this example, a counterparty to an ISDA Master Agreement becoming subject to full blocking sanctions leaves the non-sanctioned party in the difficult position of facing either an unquantifiable loss on open-ended positions or being liable for the economic impact of the sanctions on the counterparty's position (and having no control over which of these outcomes it will face). For this reason, the White Paper recommended that non-sanctioned parties should be given a reasonable period of time of not less than 30 days to close out, voluntarily unwind or novate transactions in accordance with their terms, provided that, if required under the relevant sanctions law, any payments to sanctioned parties be made into blocked accounts.

Example 1(C):

In an effort to avoid termination by NBR, BUSA notifies NBR that its notice of failure to pay is invalid because the Illegality override in the ISDA Master Agreement applies and its non-payment did not give rise to a Failure to Pay Event of Default. Instead, it sends its own notice of failure to pay to NBR in respect of its obligation to make the corresponding payment of US$1 billion on March 2. NBR responds to the notice citing the recent decree of the President of Ruritania that Ruritanian banks are prohibited

[35] In the case of a 2002 ISDA Master Agreement, NBR would be obliged to seek mid-market quotations (under Section 6(e)(ii)(3)) but under the 1992 ISDA Master Agreement these would be bid quotes at NBR's side of the market (assuming 'Market Quotation' methodology), or the value would be based on NBR's good faith estimate of its losses (or gains) from the termination of the transaction (assuming 'Loss' methodology).

from making any foreign currency payments under existing transactions with foreign banks in 'unfriendly states' without government permission and that this action constitutes a Force Majeure Termination Event.

The enactment of the anti-foreign sanctions law in Ruritania creates an additional complication for BUSA. Although BUSA does not agree that the circumstances constitute a Force Majeure Termination Event, details on the new law are not immediately clear and BUSA does not want to risk terminating the transactions for the failure to pay if it might later transpire that it was not entitled to do so. Termination for a Force Majeure Termination Event requires an 8 Business Day waiting period following the occurrence of the relevant event. The parties are now at a standstill. Meanwhile the Ruritanian dollar has further depreciated and consequently BUSA's mark-to-market exposure to NBR has increased to $3 billion.

3.4 Effects of licenses

In relation to the 2022 Russia sanctions, both OFAC and OFSI issued several general licenses granting non-sanctioned entities a limited window (usually 30 calendar days) to authorize certain activity to wind-down transactions with financial institutions that were made subject to full blocking sanctions.

The general licenses issued by OFAC typically permitted "all prohibited transactions that are <u>ordinarily incident and necessary to the wind down of transactions</u>" (emphasis added).[36] The OFSI licenses permitted the non-sanctioned entity to "wind down any transactions to which it is a party, … <u>including the closing out of any positions</u>" (emphasis added) and further permitted the non-sanctioned entity, the sanctioned entity (including its subsidiaries) and various authorized intermediaries to "carry out <u>any activity reasonably necessary</u> to effect this" (emphasis added).[37]

These general licenses provided non-sanctioned entities with the possibility of unwinding outstanding derivatives transactions and avoiding some of the issues highlighted above. These general licenses were broadly consistent with the principles espoused by ISDA in the White Paper to minimize market disruption and economic consequences for non -sanctioned entities and helped to achieve those aims.

However, the general licenses raised several issues and questions about their scope, duration and application which were not at the time fully clarified by interpretive guidance, some of which are set out below. In respect of any future sanctions actions, ISDA recommends that these issues be addressed. Given the cross-border nature of derivatives transactions, sanctions authorities should attempt to harmonize their approach, including in respect of the expiration of any licenses. Where appropriate, sanctions authorities should also provide interpretive guidance contemporaneously to

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36 *E.g.*, Department of the Treasury, OFAC, General License No. 11 under Executive Order 14024 (*now expired but available at* https://sanctions.org/turbofac/research/OFAC-Russia-related-General-License-11 (paywall)).

37 *E.g.*, HM Treasury, Office of Financial Sanctions Implementation, *General License – INT/2022/1272278*, Feb. 25, 2022, updated March 7, 2022, *available at* https://www.gov.uk/government/publications/ofsi-general-licence-int20221272278.

ensure market participants take an effective, orderly and consistent approach in winding down their positions pursuant to the relevant licenses.

(a) Timing of issuance

Some general licenses were issued contemporaneously with the implementation of the relevant sanctions which gave market participants comfort that they would be permitted to unwind their positions and allowed them to promptly commence that process and manage their relevant hedge transactions accordingly.

However, in several cases the general licenses were issued several days after the relevant entities were designated which left non-sanctioned entities in a period of uncertainty during which their contractual position could be prejudiced (e.g., by adverse changes in the market-to-market position of the outstanding transactions or the triggering of events of default or termination events by the sanctioned entity).

(b) Scope of permitted activities

The general licenses (and the accompanying interpretive guidance) did not provide complete clarity as to what actions were "ordinarily incident and necessary" (OFAC) or "reasonably necessary to effect [closing-out]" (OFSI). In particular, the general licenses gave rise to uncertainty in the market in the following areas.

(i) Whether continued performance of payment or delivery obligations under transactions during the relevant wind-down period was permitted.

Failure to perform by the non-sanctioned entity during the wind-down period could prejudice its contractual position. As outlined above, a failure to make a payment or delivery could constitute a Failure to Pay Event of Default and/or an Illegality Termination Event in respect of the non-sanctioned entity giving rise to rights of the sanctioned entity to terminate the outstanding transactions and determine the relevant termination value. This could prejudice the position of the non-sanctioned entity in negotiating any unwind of its positions with the sanctioned entity. If the parties do not agree to voluntarily unwind the transactions, this could also give rise to legal action being brought by the sanctioned entity against the non-sanctioned entity either before or after the relevant sanctions are lifted.

(ii) Whether the continued posting/collection of margin was permitted during the relevant wind-down period.

Failure to post margin by the non-sanctioned entity could also constitute a Failure to Pay Event of Default and/or an Illegality Termination Event in respect of the non-sanctioned entity giving rise to the same issues as above. Conversely, an inability to collect margin could increase exposure to the sanctioned entity during the wind-down period thereby increasing potential losses.

(iii) What methods could be used for "winding down" and "closing out"

It was unclear whether the general licenses permitted non-sanctioned entities to use all available avenues to exit their positions. Most derivatives transactions do not typically include a unilateral right of a party to terminate a transaction at any time. Absent such a termination option under the terms of a transaction, a party can only exit that transaction by: (1) exercising a contractual termination right (following the occurrence of an Event of Default or Termination Event under the ISDA Master Agreement and the satisfaction of any required pre-conditions to termination), (2) voluntarily unwinding the transaction by mutual agreement of the parties; or (3) transferring (or 'novating') its position under the transaction to a third party that is not subject to the sanctions (which typically requires the agreement of all parties). Which of these options is available to a non-sanctioned entity pursuant to general licenses may affect that party's strategy and negotiating position in exiting its positions (and the potential economic impact for that party). For example, the ability for the parties to reach a negotiated settlement may result in a more favorable and more rapid outcome for the non-sanctioned party than exercising termination rights in respect of an Illegality Termination Event which may prolong the process and give the sanctioned entity the ability to unilaterally determine the settlement amount.

(iv) Netting, set-off and settlement

Whether the position with the sanctioned entity is unwound pursuant to the contractual close-out provisions of the ISDA Master Agreement or by voluntary agreement of the parties, it is important to ascertain whether the general licenses permit the positions across multiple transactions (together with any collateral that has been posted) to be netted off. In particular, express clarification that OFAC regulations (and any equivalent regulations in other jurisdictions) that provide that a setoff against blocked property (including a blocked account) is a prohibited transfer would not prevent the netting of the value of derivatives transactions during any permitted wind-down period.

As explained in the White Paper, the ability to determine a single net settlement amount is an essential feature for the reduction of credit risk in derivatives markets. In addition, the parties' contractual documentation may also include rights of set-off between amounts owed under ISDA Master Agreements and other financial agreements between the parties. In unwinding its positions with a sanctioned entity pursuant to a general license, the ability of the non-sanctioned party to reduce those positions to a single net settlement amount is vital in rapidly mitigating any losses and eliminating any future dealings with the sanctioned entity. Once that net settlement amount has been determined it can be discharged by payment into a blocked account or as otherwise permitted by the relevant sanctions authority.

(c) Wind-down period

The general licenses issued by OFAC and OFSI provided a wind-down period of around 30 calendar days. This was in line with the principles set out in the White Paper which recommended a minimum wind-down period of 30 days. That wind down period was originally proposed as a reasonable estimate of the time it may take for major derivatives dealers to terminate their positions with a single medium-sized market counterparty that became subject to blocking sanctions. However, the experience of market participants when faced with multiple major financial institution counterparties in Russia becoming sanctions targets concurrently suggests that the 30-day wind-down period may be insufficient to enable an orderly unwind of all positions with these sanctioned entities.

Several the major Russian banks that became sanctions targets in the US, UK and EU had derivatives trading relationships under ISDA Master Agreement with many global financial institutions, all of which were required to unwind their positions within the same 30-day timeframe with limited resources and at a time of considerable market stress. In addition, missed payments and margin calls resulting from the imposition of the sanctions meant that non-sanctioned entities were having to manage potential default termination scenarios in parallel with negotiating voluntary unwinds.

These experiences suggest that the relevant wind-down period should be proportionate to the significance of the institutions subject to sanctions and a blanket 30-day window may not be the most appropriate approach in all circumstances. Factors that could be considered in making any such determination might include the number of trading entities the sanctioned entity group has, the number of derivative trading relationships the sanctioned entity group has, the number of outstanding derivative transactions the sanctioned entity group has and the aggregate notional amount of those transactions. In most jurisdictions, this information is required to be reported to trade repositories and should be available to regulators to assess in advance of any determination of an appropriate wind-down period.

(d) Different regulatory approaches

An additional challenge that market participants have faced in the context of wind down periods is ensuring compliance with multiple sanctions regimes. As highlighted in the White Paper, many of the largest derivatives dealers must comply with sanctions regimes in multiple jurisdictions, including at a minimum the US, the EU, and the UK, due to their multiple trading entities and businesses.

While OFAC and OFSI have taken a similar overall approach in issuing general licenses in respect of certain entities that have become subject to blocking sanctions, there are have been significant differences that complicate the position for non-sanctioned entities that are required to comply with both regimes. These include:

- The relevant sanctioned entities to which the general licenses apply
- The expiration dates of the relevant licenses
- The terminology used (“ordinarily incidental and necessary”; “reasonably necessary”) and how these terms should be interpreted under respective laws
- Different interpretive guidance
- The extension of certain permitted activities by OFSI to the sanctioned entity and to relevant financial intermediaries and service providers

The position is further complicated by the fact that the EU does not issue general licenses in respect of its sanctions programs and instead licensing or authorization is the responsibility of each individual EU member state. It has therefore generally proven to be more difficult for non-sanctioned entities that are subject to EU sanctions that affect derivatives to get clarity on the ability to unwind those positions.

Some of the challenges facing non-sanctioned entities described above can be illustrated, extending from the previous example:

> *Example 1D:*
>
> *On March 3, OFAC issues a General License under which "all prohibited transactions that are ordinarily incident and necessary to the wind down of transactions involving National Bank of Ruritania are authorized through April 2".*

As the general license was not issued at the same time as NBR was designated as an SDN on March 1, BUSA had determined that the sanctions made it illegal for it to make its scheduled payment on March 2. Following that non-payment NBR had sent BUSA a notice of a failure to pay pursuant to the provisions of the ISDA Master Agreement. BUSA had challenged the validity of that failure to pay notice because of the contractual Illegality override and sent its own failure to pay notice to NBR. NBR had rejected that on the basis that a Ruritanian presidential decree prevented it from making payments.

BUSA must now determine whether the general license permits it to make the payment (i.e., whether that payment is "ordinarily incident and necessary to the wind down") or whether it still considers that making that payment is not permitted and that it can still avail itself of the Illegality override. BUSA must also determine whether it is permitted to make a margin call in respect of the move in the mark-to-market value of the transaction because of the depreciation of the Ruritanian dollar and whether it can accept the proceeds of any such margin call.

BUSA must also determine whether the general license permits it to enter into negotiations with NBR to agree to voluntarily unwind the transactions in advance of the April 2 expiration date or whether it is permitted to novate the transactions to another bank that is not subject to US sanctions.

BUSA and NBR agree to attempt to voluntarily unwind the transactions while reserving their respective rights under the ISDA Master Agreement. A subsidiary of NBR has US$1bn in a deposit account with BUSA and NBR proposes that BUSA sets off the deposit against the mark-to-market value of the transactions and NBR makes a net payment of US$200m to BUSA. BUSA must determine whether the net settlement of the transaction and the set-off of the deposit against the derivatives positions is permitted by the general license. It must also determine whether it is permitted to accept the net payment from NBR.

3.5 Other issues

In addition to the challenges raised above, the imposition of the Russian sanctions in 2022 raised practical difficulties for unwinding trades with non-sanctioned entities. These included:

(a) Delivery of notices

There remains a lack of clarity whether sanctions (particularly blocking sanctions) actually permit a non-sanctioned entity to deliver the notices provided for under the provisions of Section 5 and Section 6 of the ISDA Master Agreements (which include notices of default, notices of termination events, termination notices and close-out payment calculations statements and demands) to a sanctioned entity, particularly absent any wind-down license and it would be helpful for market participants for sanctions authorities to provide confirmation under their respective programs.

The standard form ISDA Master Agreements require that notices under the provisions of Section 5 and Section 6 may not be given by email or electronic messaging system. This requirement is included to ensure that these notices (which have important consequences and require immediate action) do not get overlooked and historically counterparties have not generally amended the requirement. The option is available in the ISDA Master Agreements to deliver notices by facsimile transmission, telex or by certified or registered mail but the obsolescence of fax/telex and the potential delays in mail delivery has meant that in practice notices under the provisions of Section 5 and Section 6 are almost always given in person or by courier. Recent English case law has established that failure to deliver a notice in the contractually prescribed manner risks that notice being ineffective which can lead to serious economic consequences.

However, the delivery of default and termination notices to sanctioned entities in the territory of a hostile government presents significant challenges. These include:

- International courier services no longer operating in the jurisdiction
- Risk of employees or agents of the counterparty being subject to reprisals
- Closure or impediments to access to areas where deliveries can be made
- Difficulties in safely obtaining proof of delivery

ISDA is considering potential solutions to increase the flexibility of methods of delivery of notices. It recently published standardized amendments that market participants can agree to allow delivery of these types of notice by means of email[38] as well as initiating discussions with its members as to whether an online delivery/receipt platform could be created.[39]

38 *See* Amendments to the Notices, Illegality, and Force Majeure Event Provisions of the ISDA Master Agreement, *available at* https://www.isda.org/book/amendments-to-the-notices-illegality-and-force-majeure-event-provisions-of-the-isda-master-agreement/.

39 ISDA, *What is the ISDA Notices Hub?*, Oct. 17, 2023, *available at* https://www.isda.org/2023/10/17/what-is-the-isda-notices-hub/.

4. PART 3: EFFECT OF SANCTIONS ON REFERENCE TRANSACTIONS

4.1 Overview

As discussed in the White Paper, sanctions programs may impact reference transactions, that is derivatives transactions entered into by two non-sanctioned entities but which reference, or give exposure to, a sanctioned entity (or obligations or instruments of that sanctioned entity).

Sanctions programs may impact these reference transactions directly, e.g., the CMIC sanctions expressly prohibit dealings in 'publicly traded securities derivative of, or designed to provide investment exposure to, [securities of CMIC sanctions targets]'. In addition, these reference transactions may be affected by sanctions that prohibit or restrict activities that are necessary to perform the obligations under those transactions, such as the transfer or sale of a security to effect settlement of that transaction.

They may also impact reference transactions where the underlying asset is affected by the applicable sanctions, such as FX transactions where an underlying currency is subject to currency controls or commodity transactions where the underlying commodity is subject to export controls.

This Part 3 considers two specific instances in detail where new sanctions introduced since 2020 have impacted different types of reference transactions and the issues that have arisen in the market as a result of those sanctions. It also briefly considers a few other scenarios where reference transactions may be affected by sanctions. These examples are not exhaustive but are intended to highlight the kinds of issues that may arise for reference transactions under future sanctions programs.

4.2 Credit derivatives transactions: Effects of new debt/equity sanctions and new investment sanctions

(a) *Background*

Credit derivative transactions (principally credit default swaps) are financial contracts that allow parties to manage the risk of default of a specified third-party reference entity on its debt obligations. Credit derivatives generally reference an entity but not a single obligation of that entity. Credit default swaps, which account for the major share of the credit derivatives market, are written on a single reference entity or a basket or index of reference entities. Further background on credit derivatives transactions can be found in Section 8 of the White Paper.

(b) *Effect of new debt/ equity sanctions*

As discussed in Part 1 above, the new debt/equity sanctions introduced in respect of Russia and several Russian entities from February 2022 prohibited dealings in debt obligations of those entities issued from March 1, 2022. Both the Russian sovereign and Gazprom (which was also subject to the new debt/equity sanctions) were widely traded reference entities in credit derivatives transactions. As credit derivatives transactions reference the relevant entity and not specific obligations, the introduction of those new debt/equity sanctions meant that any new debt obligations issued by the relevant entity could potentially have been obligations that would be eligible to both trigger a credit event and then used to settle the transactions.

In March 2022, ISDA published the "Additional Provisions for Certain Russian Entities: Excluded Obligations and Excluded Deliverable Obligations" (the "Additional Provisions") and the "ISDA 2022 Russia Additional Provisions Protocol" (the "Protocol"). The effect of incorporating the Additional Provisions into a credit derivative transaction (which was automatic with respect to new transactions and achieved by adherence to the Protocol with respect to existing transactions) was to exclude any debt obligations of Russia or Gazprom that would be subject to the new debt/equity sanctions from being eligible "obligations" or "deliverable obligations" for the purposes of that credit derivative transaction. This market-wide solution followed the approach taken with respect to credit derivative transactions on Venezuela in 2017 and PDVSA when new debt/equity sanctions were issued in respect of those entities.

(c) *Effect of new investment sanctions*

On June 1, the EMEA CDS determinations committee resolved that a 'failure to pay' credit event had occurred for the purposes of credit derivative transactions written on the Russian Federation, triggering the auction settlement process for those transactions to determine the "Auction Final Price" which establishes the pay-out on the transactions.[40]

A credit derivatives auction is conducted between dealer members of the determinations committee and other institutions that elect to participate ("Participating Bidders") with respect to obligations of the reference entity meet the contractual conditions to qualify for inclusion ("Deliverable Obligations"). Each Participating Bidder engages with its customers that have outstanding credit derivative transactions to determine whether they wish to deliver or receive Deliverable Obligations in settlement of those transactions (a "Physical Settlement Request").

The auction is conducted in two stages. First, each Participating Bidder submits initial bid and offer quotations for the value of a contract to receive a fixed principal amount of Deliverable Obligations, along with the aggregate Physical Settlement Request reflecting the net position of its customers' requests and its own position. The administrators of the auction then match the quotations to determine the "Initial Market Midpoint" and match the buy and sell Physical Settlement Requests to determine the size and direction of the "Open Interest" (i.e., whether it is to purchase or to sell Deliverable Obligations) and publish that information.

In the second stage of the auction, customers of Participating Bidders (including customers that do not have outstanding credit derivatives transactions) may submit either bid or offer limit orders (depending on the direction of the Open Interest from the first stage) for Deliverable Obligations in any amount up to the Open Interest. Each

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40 Credit Derivatives Determination Committee, *Determinations Committee Decision*, Jan. 6, 2022, *available at* https://www.cdsdeterminationscommittees.org/documents/2022/06/dc-decision-01-06-22-russian-federation-interest.pdf/.

Participating Bidder then submits any limit orders received from its customers and its own limit orders (if it chooses to make any) to the Administrators. These limit orders and either the bid or offer side (depending on the direction of the Open Interest) of the Participating Bidders' initial quotations from the first round are then matched against the Open Interest in price order (i.e., starting with the lowest offer or highest bid, as applicable) and the Auction Final Price is the price of the order which fills the Open Interest. Limit orders that have been successfully matched to Physical Settlement Requests in the Auction are physically settled by delivery of Deliverable Obligations against payment of a purchase price equal to the principal amount delivered multiplied by the Auction Final Price.

The new investment sanctions on Russia, in light of the guidance provided in the OFAC FAQ 1054 published on June 6, 2022, impeded an auction from taking place to settle credit derivative transactions. Unlike the new debt/equity sanctions which only affected new obligations (which were effectively excluded from credit derivatives transactions by the Additional Provisions and the Protocol), the new investment sanctions affected all debt securities of the Russian Federation. In particular, the new investment sanctions prohibited US persons purchasing existing debt securities of the Russian Federation (or from facilitating such purchases). This affected several activities that are essential to the conduct of an auction insofar as those activities are conducted by dealers, customers and service providers that are US persons. These activities include:

- the submission by customers to Participating Bidders of Physical Settlement Requests to receive Deliverable Obligations and limit orders to buy Deliverable Obligations;

- the submission by Participating Bidders of initial bid quotations, Physical Settlement Requests to receive Deliverable Obligations and limit orders to buy Deliverable Obligations;

- the deemed entry by Participating Bidders with each other and their customers into binding contracts to physically settle their credit derivative transactions where limit orders are matched against the Open Interest and the physical settlement of such contracts;

- the decision to hold an auction (and associated determinations on certain parameters of the auction) by the determinations committee, the administration of the auction process by the administrators and the publication of the auction terms;

- the involvement of any person in the Auction or the settlement of credit derivative transactions pursuant to the outcome of the Auction to the extent that such action would constitute facilitation of purchases of existing debt obligations of the Russian Federation.

The impairment of these key elements of the auction process, and the associated risk that any such auction would fail or produce an undesirable outcome, made it virtually impossible for an auction to be held in light of the new investment sanctions and would have resulted in the determinations committee issuing a resolution that no auction would take place.

Absent any auction, all uncleared credit derivative transactions would have been required to have been settled bilaterally pursuant to physical settlement or fallback cash settlement provisions using the price of the obligations determined by a dealer poll process, while clearing houses would have been obliged to determine a single uniform settlement price for cleared trades. Such an outcome would have potentially resulted in disorderly processes and asymmetrical outcomes, as well as potential systemic issues for both cleared and non-cleared markets.

(d) *The CDS auction general license*

In response to concerns raised by derivatives market participants, on July 22, 2022, OFAC issued General License No. 46 "Authorizing Transactions in Support of an Auction Process to Settle Certain Credit Derivative Transactions Prohibited by Executive Order 14071" (the "**Auction GL**").

The Auction GL authorized (a) all transactions related to the establishment, administration, participation in, and execution of an auction process as announced by the EMEA Credit Derivatives Determination Committee ("the auction") to settle credit derivative transactions with a reference entity of "the Russian Federation" (b) the purchase or receipt of debt obligations of the Russian Federation by US persons prohibited by section 1(a)(i) of E.O. 14071 for the period beginning two business days prior to the announced date of the auction and ending eight business days after the conclusion of the auction and (c) all transactions ordinarily incident and necessary to facilitating, clearing, and settling transactions authorized by paragraph (a) or (b).

The authorizations provided by the Auction GL enabled the auction to be held on September 12, 2022. The auction proceeded smoothly and established the Auction Final Price and credit derivatives transactions were settled pursuant to the Auction Final Price and any Physical Settlement Requests matched in the auction.

(e) *Future sanctions programs*

The possibility remains that future new investment-type sanctions (or other sanctions affecting dealing in all of an issuer's debt obligations) could jeopardize the orderly settlement of credit derivatives transactions referencing that issuer entity. Although the Auction GL permitted the auction settlement of credit derivatives transactions referencing Russia, OFAC (and other sanctions authorities) should provide equivalent relief on a case-by-case basis where there is no obvious benefit for sanctioned entities from such relief to ensure that the market continues to function for the benefit of all market participants.

4.3 Equity Derivatives: effects of the CMIC sanctions

(a) *Background*

Equity derivatives (including equity forwards, equity options and equity swaps) are transactions which are settled either by reference to the price of equity securities or the level of equity indices on one or more specified dates or by delivery of the relevant securities. Further information about these transactions is set out in the White Paper.

As set out above the CMIC sanctions prohibited US persons from the purchase and sale of specified CMIC sanctions. The Hang Seng Index ("**HSI**") is the principal stock-market index in Hong Kong and comprises many of the largest companies listed on the Hong Kong Stock Exchange. When the CMIC sanctions were introduced, the original list of CCMCs included three constituents of the HSI: China Mobile, China Unicom and China National Offshore Oil Corporation. The updated CMIC list also included Xiaomi, also a component of the HSI.

As one of the major global stock-market indices (and a common way for investors to get broad exposure to the Chinese equity market), many equity derivative transactions reference the level of the HSI, either by itself or in a basket of global indices or by referencing exchange-traded funds which themselves reference or have exposure to these indices. Sophisticated investors may get exposure to the index by entering into these equity derivative transactions directly with sell-side dealer banks. Other investors (such as retail investors or pension plans) may purchase financial products (such as unit trusts or insurance policies) issued by financial entities which themselves enter into equity derivative transactions to provide the relevant return to those investors in financial products.

(b) *Effect of the CMIC sanctions*

The CMIC sanctions have principally impacted equity derivative transactions in two ways. First, some equity derivative transactions may constitute 'publicly traded securities derivative of' relevant securities of CMICs. Second, the CMIC sanctions may also impact the ability of the sell-side dealers that have entered into equity derivative transactions to hedge their obligations under those transactions by buying and selling the underlying securities of CMICs. Each of these issues is considered below.

(i) *Securities derivative of relevant securities*

OFAC FAQ 860, as revised in June 2021, gives more information about the financial instruments covered by the prohibitions applicable to "publicly traded securities that are derivative of such securities or are designed to provide investment exposure to such" publicly traded securities.[41] The response to the FAQ explains that examples of financial instruments covered by this provision <u>include, but are not limited to, derivatives (e.g., futures, options, swaps)</u>, warrants, American depositary receipts (ADRs), global depositary receipts (GDRs), exchange-traded funds (ETFs), index funds, and mutual funds, <u>to the extent such instruments also meet the definition of "publicly traded security."</u>

'Publicly traded securities' are defined in E.O. 13959, as amended by E.O. 14032, to "include [..] any 'security' as defined in s. 3(a)(10) of the Securities Exchange Act of 1934, denominated in any currency that trades on a securities exchange or through the method of trading that is commonly referred to as 'over the counter' in any jurisdiction."

[41] OFAC FAQ 860 https://ofac.treasury.gov/faqs/860

The FAQ and the definition raise questions regarding the scope of the prohibition in respect of derivatives. In particular, neither the FAQ nor the definition are expressed to be exhaustive (both use the term 'includes'). Some commentators have suggested that the executive order and FAQ 860 support a position that certain instruments regulated by agencies other than the SEC, including CFTC-regulated instruments providing exposure to broad-based securities indices (such as the Hang Seng Index), should be excluded from the coverage of the executive order. This is because there are express exclusions from the '34 Act definition for both 'securities futures' and 'swaps' on broad-based indices (and assuming an interpretation that the definition of security in the executive order is limited to the '34 Act definition). However, this interpretation would create a somewhat artificial distinction between equity derivatives of equivalent economic effect as (for example) options would not benefit from that exclusion (because section 1a(47)(B)(iii) of the Commodity Exchange Act excludes from the definition of swap "any … option… on any … index of securities … that is subject to [the '33 Act and '34 Act]").

OFAC FAQ 861, as revised in June 2021, states "any purchase or sale of publicly traded securities, or any publicly traded securities that are derivative of, or are designed to provide investment exposure to such securities, of any CMIC listed on the NS-CMIC List is prohibited, regardless of such securities' share of the underlying index fund, ETF, or derivative thereof."[42] This approach differs from OFAC guidance in the context of the Venezuela new debt/equity sanctions where OFAC applied a predominance test for synthetic exchange traded funds to determine which funds fell within scope of those sanctions.

If an equity derivative transaction falls within the prohibition, this raises the question of whether the performance of the parties' respective obligations under that transaction (including the settlement of that transaction) are permitted. As discussed earlier,[43] the original executive order contained a 365-day divestment window during which US persons were authorized to divest their holdings. This raised questions of whether an Illegality termination event may arise upon expiration of the divestment window (on the basis the relevant party's obligations may become unlawful).

However, E.O. 14032 (and the accompanying FAQ 862 from OFAC) provided that US persons, including US funds and related market intermediaries and participants, are not required to divest their holdings but if they choose to do so, such divestment was required to be completed by November 11, 2021 (implying that any holding after that date would be required to be maintained and could not be divested). This is an important consideration for derivatives counterparties where a 'divestment' of a position might occur by virtue of an early unwind or termination and not just a sale or novation of the position to another party.

(ii) *Hedging of obligations*

In circumstances where equity derivatives referencing CMICs are not unwound or otherwise divested, the CMIC sanctions may still have significant implications for those

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[42] Department of the Treasury, OFAC, FAQ 861, *available at* https://ofac.treasury.gov/faqs/861.

[43] *Id*, at note 13.

transactions. In particular a sell-side dealer in equity derivatives would typically hedge its net exposure across all its derivatives portfolios by buying and selling the underlying shares (or other derivatives on those underlying shares). If the relevant trading entity of that dealer is subject to the sanctions applicable to US persons, it would be prevented from purchasing the underlying shares of the CMICs (or derivatives on those shares) on its own behalf. Trading entities not directly subject to the jurisdiction of the US sanctions may still apply US sanctions globally, particularly if they have significant US businesses, and elect not to deal in those shares.[44]

Standard equity derivatives transactions entered into under ISDA Master Agreement are documented by means of transaction confirmations which incorporate the 2002 ISDA Equity Derivatives Definitions (the "**Equity Definitions**"). The Equity Definitions include certain fallbacks to address situations when circumstances affect the ability of a party (typically the sell-side dealer) to hedge its position under a transaction (referred to as "Additional Disruption Events" in the Equity Definitions). These include those set out below. However, it is important to note that none of these standard Additional Disruption Events has been specifically drafted in contemplation of the terms or practical effect of any specific type of sanctions program or sanctions programs generally.[45]

(A) Change in Law

Under s. 12.9(a)(ii) of the Equity Definitions, a 'Change in Law' occurs if: (a) there is adoption of or change in any applicable law; (b) a party determines in good faith that either (i) it has become illegal[46] to hold, acquire or dispose of Shares or 'Hedge Positions' relating to the Transaction or (ii) it will incur a materially increased cost in performing its obligations. The consequences of a Change in Law under s. 12.9(b)(i) of the Equity Definitions is that either party may elect to terminate the Transaction on at least two trading days' notice (or less if required to comply with a Change in Law) and the "Determining Party" (the dealer) will determine the "Cancellation Amount" payable between the parties. The Cancellation Amount is determined under s. 12.8 of the Equity Definitions and is broadly comparable to the "Close-out Amount" methodology under the 2002 Master Agreement.

(B) Hedging Disruption

Under s. 12.9(a)(v) of the Equity Definitions, a "Hedging Disruption" occurs if the Hedging Party (the dealer) is unable, after using commercially reasonable efforts to

44 Although note that entities that are not directly subject to the jurisdiction of the US sanctions may not be able to avail themselves of termination and other rights that triggered upon it becoming illegal to deal in the relevant shares, *e.g.*, the Change in Law Additional Disruption Event discussed in sub-paragraph (A) below.

45 See paragraph 2.1 above for further discussion on the challenge involved in derivatives documentation specifically addressing sanctions risks *a priori*.

46 Note that the Change in Law definition contemplates that the adoption of or change in applicable law must have already occurred before the Additional Disruption Event is triggered. In the context of the CMIC sanctions, it may be undesirable for the Determining Party to unwind its hedge positions after the trading restrictions have come into effect (and doing so may lead to increased costs for the client when there is no longer liquidity in the market).

either (i) acquire, establish, re-establish, substitute, maintain, unwind or dispose of transactions/assets it deems necessary to hedge the equity price risk or (ii) realize, recover or remit the proceeds of such transaction or asset. The consequences of a Hedging Disruption under s. 12.9(b)(iii) of the Equity Definitions is that the Hedging Party may elect to terminate the Transaction on at least two trading days' notice and the Transaction and the "Determining Party" (the dealer) will determine the "Cancellation Amount" payable between the parties. If the Hedging Party elects to terminate the Transaction, the "Determining Party" will determine the "Cancellation Amount" (calculated as above) payable between the parties.

(C) Increased Cost of Hedging

Under s. 12.9(a)(vi) of the Equity Definitions, an 'Increased Cost of Hedging' occurs if the Hedging Party (the dealer) would incur a "materially increased amount of tax, duty expense or fee" to either (i) acquire, establish, re-establish, substitute, maintain, unwind or dispose of transactions/assets it deems necessary to hedge the equity price risk or (ii) realize, recover or remit the proceeds of such transaction or asset. The consequences of an Increased Cost of Hedging under s. 12.9(b)(vi) of the Equity Definitions is that the Hedging Party will calculate any associated "Price Adjustment" and the other party may elect within two trading days either to pay the Price Adjustment, reflect it in amended terms of the Transaction or to terminate the Transaction (and if no election is made the Transaction will terminate). If the party elects to terminate the Transaction (or makes no election), the "Determining Party" (the dealer) will determine the "Cancellation Amount" (calculated as above) payable between the parties.

Other provisions of the Equity Definitions may also be relevant (and parties may have agreed additional or alternative bespoke fallbacks). However, in general, the consequences of a dealer determining that it is no longer able to hedge its position are that the counterparty will be subject to increased costs or that the transaction will be terminated (and the termination payments will reflect any change in value of the transaction arising from CMIC sanctions). This can result in economic losses for investors and also potentially lead to unhedged liabilities where the relevant equity derivative transactions are intended to hedge financial products that are not subject to the same termination rights as a result of the sanctions.

To illustrate the issues raised by the CMIC sanctions, consider the following example.

Example 2(A):

*USA Life ("**Life**") is a United States life insurance company that offers its customers a range of life insurance policies where the returns on those policies are linked to the performance of various equity indices around the world. One of its products offers a return linked to the best performing of several indices, one of which is the Hang Seng Index. In order to hedge its obligations to pay the returns linked to the indices on its policies, Life enters into a series of bespoke long-dated index-linked equity options designed to correlate to those obligations with Bank USA ("**BUSA**"), a global dealer bank incorporated in the United States. Life pays an upfront premium for those options.*

When the original CCMCs sanctions are introduced under Executive Order 13959 on November 12, 2020, several of the listed CCMCs in the executive order are components of the Hang Seng Index. The operator of the index indicates that these companies will not be removed from the index. The original executive order authorized divestment of securities that are derivative of securities of CCMCs prior to November 11, 2021. BUSA informs Life that it believes that the index-linked equity options are subject to the executive order.

In January 2021, when the amendments made by E.O. 13974 to E.O. 13959 clarified that possessing targeted securities beyond the applicable divestment deadline would constitute a substantive violation, BUSA informs Life that it believes that the index-linked equity options should be unwound by mutual agreement. Insurance policies are not securities for the purposes of the executive orders so are unaffected.

In this situation Life is faced with the prospect of having to agree to terminate the transactions at a value that is less than the value prior to the implementation of the sanctions. Following termination of the transactions, Life may be unable to find replacement arrangements that would provide a perfect hedge for its obligations under the policies as the transactions were specifically designed to correlate to the policies and other dealers may no longer offer exposure with respect to the CCMC index constituents. Bespoke arrangements to match the obligations closely are likely to be illiquid and expensive to obtain. In addition, Life may not be able to amend or terminate its obligations under the policies as these are not directly affected by the sanctions as outside of the scope of the affected instruments and the policyholders can continue to hold them.

Example 2(B):

Life is in negotiations with BUSA to unwind the transactions when the Executive Order 14032 is issued revoking Executive Order 13974 and amending Executive Order 13959. Life determines that the effect of the new executive order is that Life no longer has to divest itself of the transactions prior to November 11, 2021. However, BUSA informs Life that it has become increasingly difficult for it to hedge its obligations in respect of the transactions due to its inability to buy and sell securities of CMICs and therefore it wishes to restructure the transactions or terminate them citing the Change in Law and Hedging Disruption Additional Disruption Events in the Equity Definitions.

In this scenario, although Life is no longer required to terminate the transactions, it is unclear whether BUSA will allow the transaction to continue given the difficulties in hedging the exposure to the components of the Hang Seng Index that are subject to the sanctions. In addition, whether the parties would be permitted to amend, novate or terminate the transactions (whether voluntarily or following an event of default or termination event) following the November 11, 2021 deadline is unclear.

(c) *Future sanctions programs*

These challenges presented for certain equity derivatives transactions from the CMIC sanctions illustrate that any sanctions program that restricts dealings in securities of major corporations that are widely traded can have significant practical consequences for many financial entities and can give rise to losses to investors (including retail investors) beyond any value impairment in the securities of the sanctioned entities. In particular the lack of any de minimis threshold means that sanctions can have a disproportionate effect on index-linked transactions. The market would also benefit from greater clarity as to the derivatives transactions that are intended to be directly affected by the sanctions measures and the actions that may be taken under those instruments (including following the expiration of any divestment period). Consideration should also be given to the inclusion of a limited hedging exemption for trading securities to allow dealers to continue to be able to hedge their positions in respect of transactions that are permitted to remain in place under the sanctions.

4.4 Other issues for Reference Derivatives

(a) *Commodity Derivatives*

The sanctions introduced against Russia include significant measures prohibiting the import, acquisition, supply and delivery of commodities, notably oil and oil products, coal and coal products, iron and steel and gold.

These sanctions may also prohibit the provision of financial services in connection with activities relating to these physical commodities. For example, Australian sanctions regulations prohibit the provision of financial services (which expressly include 'financial derivatives') if it assists with, or is provided in relation to, the import, purchase or transportation of a sanctioned import.[47] Sanctioned imports from Russia include oil, refined petroleum products, natural gas, coal and other energy products, as well as gold exported from Russia. Equivalent US import restrictions on oil, gas and coal products under Executive Order 14066 also prohibit "any approval, financing, facilitation, or guarantee" by a US person of a transaction by a foreign person that would be prohibited by the sanctions.[48] UK sanctions refer to the provision of "financial services in pursuance of or in connection with an arrangement whose object or effect is" prohibited import, supply or delivery.[49]

Where sanctions regulations include prohibitions on the provision of such 'financial services' that may include derivatives contracts or 'financing or facilitation', financial institutions may face uncertainty as to the circumstances in which derivatives activity may be closely enough connected to physical activity in the commodity that it can said that such derivative activity 'assists with, or is provided in relation to' or 'facilitates' or is provided 'in pursuance of or in connection with' the relevant physical activity. In particular, commodity derivative contracts do not generally specify the origin of the

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[47] Australian Government Federal Register of Legislation, *Autonomous Sanctions Regulations 2011*, March 28, 2022, *available at* https://www.legislation.gov.au/Details/F2022C00330; Australian Government Federal Register of Legislation, *Autonomous Sanctions (Import Sanctioned Goods—Russia) Designation 2022*, March 10, 2022, *available at* https://www.legislation.gov.au/Details/F2022L00310.

[48] *Id.* at note 15.

[49] *The Russia (Sanctions) (EU Exit) Regulations 2019*, *available at* https://www.legislation.gov.uk/uksi/2019/855/regulation/28#commentary-key-32d855685e09d2faef9cb8fced8d0bc6.

relevant commodity being traded or might specify a benchmark price which seeks to represent the market price of a commodity that is not a sanctioned commodity.[50] In either case, a financial institution entering into a commodity derivative with a client is unlikely to have information about whether the client is seeking to enter into the commodity derivative contract as a proxy to the sanctioned commodity for hedging or financing purposes.

Similar issues were raised in the White Paper in respect of the extent to which derivatives might constitute 'facilitation' or 'services in support' of the raising of new debt by entities subject to new debt/new equity sanctions. The recommendation of the White Paper was that derivatives transactions entered into in the ordinary course of a derivatives trading relationship should not be considered 'facilitation' or 'services in support' absent an express link to the prohibited activity. Market participants would benefit from guidance from sanctions authorities that commodity derivatives transactions would not generally be prohibited under the relevant regulations.

(b) *Securities financing transactions*

Securities financing transactions ("**SFTs**"), including repurchase transactions (repos) and securities lending transactions (stock loans) have historically been documented under specifically tailored industry association agreements and not under ISDA Master Agreements. However, in February 2022, ISDA published the 2022 ISDA Securities Financing Transactions Definitions and related documents, which allow firms to enter into derivatives and SFTs under a single ISDA Master Agreement.[51] As a result of this development, ISDA anticipates that a significant number of SFTs may be transacted under ISDA Master Agreements in the future.

The Russia sanctions measures had a significant impact on certain repo and stock lending transactions where the underlying securities for those transactions were issued by entities that became subject to blocking sanctions or other restrictions on trading of their securities (or became frozen due to Russian issuer's lack of access to foreign clearinghouses). The inability to acquire and/or access the relevant securities prevented parties from being able to satisfy their delivery obligations under the settlement provisions of the transactions and also created difficulties in valuing those securities to give effect to the alternative settlement provisions.

As the vast majority of SFTs are documented under other non-ISDA agreements, more detailed consideration of the impact of the recent sanctions programs on SFTs and the

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[50] Physically-settled exchange-traded commodity futures will generally require that the commodity delivered against the contract complies with certain requirements, including - in the case of metals – that it was refined by one of a specified list of acceptable refiners. Where a refiner is brought within scope of sanctions, the entity is generally withdrawn from the list. In addition, there are examples of entities being delisted for policy reasons, even where not technically within the scope of sanctions. However, a holder of a position will have no further visibility on the origin of the underlying commodity that they will deliver, or of which they will take delivery, against their position and so is ultimately reliant on the refiner ensuring that their feedstock supply chains are sanctions compliant.

[51] *See* ISDA, *The 2022 ISDA Securities Financing Transactions Definitions: Current and Future Use Cases*, September 2022, *available at* https://www.isda.org/a/jX3gE/The-2022-ISDA-Securities-Financing-Transactions-Definitions-Current-and-Future-Use-Cases.pdf.

provisions of those agreements is outside the scope of this paper. However, in the event that SFTs become more commonly documented under ISDA Master Agreements then future sanctions programs are likely to give rise to similar considerations as other reference transactions discussed elsewhere in this paper, particularly in circumstances where the relevant underlying securities become subject to trading restrictions.