

Sanctions: ripples offshore

A team of offshore lawyers explain the impact of Russian sanctions in the British crown dependencies and offshore territories.

The sanctions imposed by the European Union, the United Kingdom and the United States, among others, in the wake of Russia's unjustified invasion of Ukraine have raised a number of issues for the British crown dependencies (CDs) and overseas territories (OTs).

This article looks at the financial sanctions regimes applicable in the British Virgin Islands (BVI), the Cayman Islands, Guernsey and Jersey, and the key practical challenges currently being faced in those jurisdictions, including by IPs and those advising them. Due to the nature of business carried on in those jurisdictions, which are popular domiciles for investment funds due to their tax neutrality, the context in which issues have tended to arise are in relation to the ongoing management of investments that are subject to sanctions or in relation to distributions out of a fund which may be caught by sanctions. Issues have also arisen in relation to charging professional fees.

The financial sanctions frameworks

The financial sanctions applicable in the four jurisdictions considered by this article are broadly similar. The BVI and the Cayman Islands are OTs and Guernsey and Jersey are CDs. As such, the financial sanctions in force are essentially the same as those in force in the UK (see page 12 for more on the legal situation within the UK). The UK implements both the UN sanctions and its own financial sanctions, via a combination of primary and secondary legislation (ie statutes and statutory instruments). UK sanctions are extended to or adopted by the OTs and CDs, with certain modifications, by Overseas Territories Orders or other legislation in the CDs. In addition, the governors of the BVI and Cayman Islands, the Policy & Resources Committee in Guernsey and the Ministry of External Relations in Jersey can impose further financial sanctions under domestic legislation.

The financial sanctions in force in each of the four territories are applicable to any person (whether natural or legal) in, or carrying out activities in, that jurisdiction, and all nationals and legal persons established under the laws of that jurisdiction, irrespective of where in the world they are

located, as well as to certain non-nationals ordinarily resident therein.

Although financial sanctions imposed by the EU, US and others do not have direct legal effect in the OTs or CDs, in practice they may be observed by service providers in those offshore jurisdictions.

Financial sanctions and designated persons

Financial sanctions come in many forms, with the most common types including asset freezes and restrictions on access to a variety of financial markets and services, including investment bans, restrictions on access to capital markets or international payment systems, and directions to cease banking relationships and activities. As a first step, review of restricted activity or 'sectoral sanctions' that may apply to the type of financial services or investment must be undertaken both at the time of engagement and frequently thereafter against the most current sanctions legislation.

In order to know whether a financial sanction is applicable to a particular individual or entity, daily checks need to be conducted against the consolidated sanctions list of designated persons (the consolidated list) published by HM Treasury's Office of Financial Sanctions Implementation (OFSI).¹ The consolidated list does not contain any domestic sanctions imposed in one of the offshore jurisdictions, or any listings imposed by other countries or organisations (such as the EU or the US), which need to

be checked separately. The same difficulties that arise onshore in respect of reconciling this 'patchwork quilt' of financial sanctions, as well as the differing approaches taken by the EU, the UK and the US, arise in those offshore jurisdictions.

In a funds context, as the fund vehicle conducts initial and ongoing due diligence on its investors, including the identification and verification of the ultimate beneficial owners of an investor who is not a natural person, it is generally straightforward to identify whether a designated person is invested in an investment fund. Where a designated person has (as is invariably the case) invested via a separate entity or structure, the relevant sanctions regulations will set out the rules to be considered in determining whether the designated person 'owns or controls' that investment. This comes down to whether the designated person holds (directly or indirectly) more than 50% of the shares (or equivalent rights to share in profits or capital) or voting rights (or equivalent rights) in the vehicle, or whether the designated person has the right (directly or indirectly) to appoint or remove a majority of the board of directors (or equivalent management body) of the entity. An important point to note is the UK does not aggregate the ownership or controlling interests of multiple designated persons to reach the 50% or more ownership interest, unlike the EU and US Russian sanctions regimes.

So far, so good. However, the position becomes more difficult when the investor in a fund is not a designated person, but a close relative such as a spouse or child. These kinds of relationships may be identified as part of the onboarding due diligence process undertaken by investment funds, where such persons are subjected to enhanced due diligence by virtue of being treated as 'politically exposed persons', but additional checks may be necessary. The UK sanctions regulations provide that a person is owned or controlled by a designated person if it is reasonable, in all the circumstances, to expect that the designated person would be able to have that person's affairs conducted in accordance with the designated person's wishes. This is a very broad, objective test which may be difficult to apply in practice.

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Asset freezes

Where an investment fund knows, or has reasonable cause to suspect, that it is in possession or control of, or is otherwise dealing with, funds or economic resources owned or controlled by a designated person, the fund must freeze those funds or economic resources and not deal with them or make them available to, or for the benefit of, the designated person (absent any exemption or licence). This is commonly referred to as an ‘asset freeze’ and is the main way in which offshore funds have, so far, been impacted by the recent sanctions escalation.

The acts constituting ‘dealing’ with an investor’s interest in a fund are extensive, including (among other prohibited actions) using, altering, moving, transferring or allowing access to the interest and dealing with the interest in a way that would result in any change in its volume, amount, location, ownership or character. In practice, and in the absence of any on-point general licence or guidance, this means that a fund must not process any redemption of, or make any distributions in respect of, the frozen interest, must not accept any additional subscriptions from the designated person, and must not otherwise alter, move or allow the designated person to access or receive the benefit of the investment. Additional complexities may arise in practice, dependent upon the precise terms of an investment fund, in determining how far an ‘asset freeze’ may extend and what actions, such as payment of fees, may be permitted at the fund level.

The position also changes where, rather than a minority interest, a designated person owns or controls a majority interest of greater than 50% in an investment fund. Where this fact pattern exists, the entire fund vehicle will be considered to be ‘owned and controlled’ by the relevant designated person and will itself become a sanctioned vehicle. There must then be

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no ‘dealings’ with that entity or its assets, meaning that, for service providers such as IPs and legal counsel, no fees can be paid absent a licence, and many service providers will terminate the relationship.

Reporting and licences

Where an investment fund and its service providers know or have reasonable cause to suspect contact with a designated person, they must also comply with their respective reporting obligations by submitting the appropriate reports to the relevant authority, as soon as is practicable. Where the circumstances warrant it, ie where there is a suspicion of criminal conduct such as an attempt to circumvent applicable financial sanctions, additional suspicious activity reporting may also be required. The governors of the BVI and Cayman Islands are the competent authorities for implementation of financial sanctions measures in those jurisdictions, though in the Cayman Islands, the power to receive sanctions reports has been delegated to the Cayman Islands Financial Reporting Authority. The Minister for External Relations in Jersey and the Policy & Resources Committee in Guernsey are the competent authorities for sanctions legislation and receiving reports in the CDs.

The competent authorities may also issue licences to allow an activity or transaction that would otherwise be prohibited by the applicable sanctions legislation. A licence may either be general or specific. Guernsey has issued several general licences in relation to the current Russian sanctions, mirroring similar general licences in the UK. While no general licences have been issued in the BVI, Cayman or Jersey, it is still early days. Governments grant general licences to permit parties a period of time to wind-up their business dealings with designated persons in an orderly manner or may permit ongoing limited activity where it is deemed beneficial overall. A party may apply for a specific licence, only applicable to them that may be granted in certain circumstances or ‘derogations’ set out in the applicable sanctions regulations. Usually, licences will be capable of being applied for to meet the ‘basic needs’ of a designated person, to enable payment of reasonable legal fees, to pay reasonable fees or service charges arising out of the holding or maintenance of frozen funds or economic resources, to implement certain pre-existing judicial decisions and/or to enable anything to be done to deal with an extraordinary situation.

Summary

The Russian invasion of Ukraine is an extraordinary situation. Sanctions legislation does not and cannot anticipate the nuances of each industry sector so, whilst the offshore investment industry is certainly responding and adjusting to the fast pace of change in this area, it is hoped that, with time, we will see some guidance, or standard practices evolve, resolving some of the practical questions and obstacles currently being seen. □

¹ The consolidated list is available here: <https://www.gov.uk/government/publications/financial-sanctions-consolidated-list-of-targets>.



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