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NSD's Removal from Russian Custody Infrastructure: Sanctions Implications

October 23, 2024

U.S. and UK sanctions imposed on the Russian National Settlement Depository ("NSD"), a centralized custodian for securities of publicly traded Russian companies, in June 2024 created new compliance challenges for Western investors seeking to divest their holdings in Russian public companies. In response, Russian authorities recently developed a parallel share custody system for shareholders from "*unfriendly*" countries,[1] bypassing NSD.

The U.S. Treasury Department's Office of Foreign Assets Control ("OFAC") immediately called on U.S. investors and financial intermediaries to block shares of Russian public companies despite NSD's removal from the share custody chain. The UK Office of Financial Sanctions Implementation ("OFSI") and the European Commission have not yet followed OFAC's lead.

Below, we describe the amendments to the Russian share recordation system that resulted in the removal of NSD from the share custody chain and summarize implications for ongoing divestments from the Russian market.

Russian Custody of Non-Russian Shareholdings Before the Change

Before the Russian regulations discussed in this Update took effect, under Article 24(1) of Federal Law No. 414-FZ dated December 7, 2011 "On the Central Depository" (as amended, the "CD Law"), NSD as a central depository in Russia was the only custodian that had the right to hold custody nominee accounts[2] directly at issuers' registrars. Thus, non-Russian investors usually held local shares of Russian public companies

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[1] The Russian Government, in its Regulation No. 430-r dated March 5, 2022 (as amended), identified the states and territories that imposed sanctions on Russia or otherwise condemned Russia's actions in Ukraine as "*unfriendly*" jurisdictions. As of the date of this Update, the list of "*unfriendly*" jurisdictions contains more than 50 states and territories, including the United States, all EU member states, the United Kingdom (including all British Overseas Territories and Crown Dependencies), Switzerland, Australia, and Canada. Jurisdictions not included on this list are considered "*friendly*" by the Russian Government.

[2] Under Articles 8.2(8) and 8.3 of the Federal Law No. 39-FZ dated April 22, 1996 "On the Securities Market," a custody nominee account is used to record the securities that are not owned by a custodian but rather are held by such custodian on behalf of its clients.

through a chain of non-Russian custodians with nominee accounts at Russian custodians which, in turn, had custody nominee accounts at NSD.

Since the imposition of sanctions following Russia's invasion of Ukraine in 2022, custody accounts opened by Russian custodians for persons from "*unfriendly*" jurisdictions (including custodians from such jurisdictions) generally have been considered restricted "type-C" accounts with a very limited list of permitted transactions. Most importantly, securities held in a "type-C" account cannot be transferred to a new owner without an approval of the Russian authorities.

Effect of Western Sanctions on NSD

On June 12, 2024, OFAC designated NSD as a Specially Designated National. On June 13, 2024, OFSI followed suit with sanctions, adding NSD to the UK asset freeze list. Before that, on June 3, 2022, NSD was included on the asset freeze list of the European Union. These designations had a similar effect: any transaction involving shares of Russian public companies or other securities held through custody nominee accounts at NSD, and any transaction with dividends received from such custody nominee accounts at NSD would be a prohibited dealing with NSD without a license or exemption.

OFAC and OFSI issued general licenses to allow divestment of securities, including shares of Russian public companies, until October 12, 2024, notwithstanding the NSD nexus.[3] OFAC and OFSI intended that, once their respective general licenses expired, U.S. and UK investors would block or freeze Russian securities held in "type-C" custody accounts and cease any attempts to divest them, without specific authorization.

Change in Share Recordation of Russian Public Companies

A few days before expiry of the U.S. and UK general licenses described above, on October 2, 2024, the President of the Russian Federation enacted Decree No. 840 establishing a new framework regulation for the transfer by Russian custodians of "type-C" custody accounts from NSD to Russian issuers' registrars. In furtherance of Decree No. 840, on October 3, 2024, the Board of Directors of the Central Bank of Russia adopted two decisions, including a decision outlining the procedure and timing of the transfer (the "CBR Procedural Decision").

Among other actions, the CBR Procedural Decision suspended Article 24(1) of the CD Law and required Russian share registrars to (i) open direct "type-C" accounts (the so-called "*personal type-C accounts of nominee holders*") for custodians that have "type-C" custody accounts opened for their clients and (ii) together with NSD and Russian custodians, effect transfers of shares from the custodians' accounts at NSD to such new

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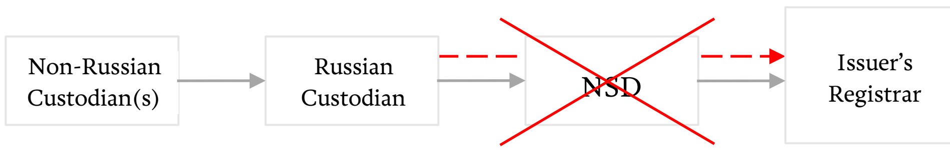
[3] See OFAC General License 100A and OFSI General License INT/2024/4919848.

direct "type-C" accounts, thereby removing NSD from the share recordation chain in respect of any shares held in "type-C" custody accounts. No action from the issuer, shareholders or non-Russian custodians was required to complete these transfer procedures, nor could any such shareholder or custodian prevent these transfers. The new share recordation chain is shown in the diagram below:



Under the CBR Procedural Decision, transfers to the new direct "type-C" accounts at the registrars should have been completed by October 12; therefore, most non-Russian holders of Russian publicly traded shares should no longer have NSD in the custodian chain. The transfer procedures effected by Decree No. 840 and the CBR Procedural Decision apply only to "type-C" custody accounts and do not cover custody accounts of Russian or "*friendly*" holders and nominees. Nor do they apply to custody of Russian issuers' debt securities, which remain held through NSD.

Consequences for Divestment Transactions

Removal of NSD from the share recordation chain was likely intended by Russia to remove Russian publicly traded shares held by "*unfriendly*" investors from the sanctions imposed on NSD. In fact, once NSD no longer holds shares of Russian public issuers in nominee accounts with the issuers' registrars for the holders' custodians and these custodians have accounts directly with the issuers' registrars, it would appear difficult to establish a basis for freezing such shares under Western sanctions.

However, OFAC has made it very clear that it requires U.S. persons to block all Russian shares previously held through NSD, even if the shares were not held through NSD at the time OFAC's general license expired.[4] OFAC made clear that it views Decree No. 840 as an attempt to evade or avoid OFAC's sanctions on NSD and indicated that it would be investigating Russian registrars for future designation. Therefore, U.S. holders of Russian publicly traded securities, including shares of Russian public issuers, are no longer able to divest their holdings without a specific license from OFAC. We understand that OFAC is willing to consider such license applications on a case-by-case basis.

EU and UK sanctions make it rather difficult from a purely legal perspective to apply sanctions restrictions to Russian shares now that the custody chain no longer includes NSD, especially if, in the case of UK sanctions, the relevant transfers occurred before expiration of the OFSI general license. Nevertheless, EU and UK investors considering

[4] OFAC FAQ 1197.

divestments of Russian shares should monitor any OFSI and European Commission guidance on the recent changes to the Russian share recordation system.

While U.S. investors should treat any dividends received as blocked, UK and EU investors may want to consider the benefits of segregating any dividends that may be paid following the removal of NSD from the custodial chain from any dividend amounts that were paid following imposition of UK and EU sanctions on NSD.

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Please do not hesitate to contact us with any questions.

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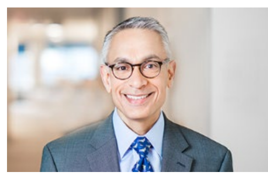

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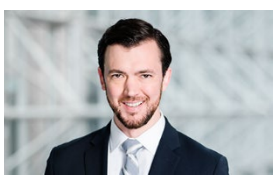

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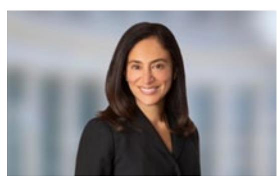

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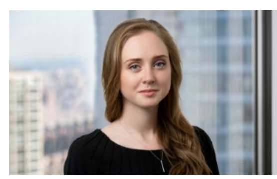

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