

June 27, 2014

Adam J. Szubin, Esq.
Director
Office of Foreign Assets Control
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Potential Sanctions Regarding Ukraine

Dear Mr. Szubin:

This letter is a follow up to conversations that representatives of The Clearing House Association L.L.C. (“The Clearing House”)¹ recently had with the Office of Foreign Assets Control (“OFAC”) regarding the potential adverse effects that broad sanctions on Russian financial institutions could present to U.S. financial institutions. The first part of the letter summarizes some of the adverse effects that some potential or anticipated sanctions could pose and suggests possible mechanisms to mitigate those effects. The second part shows some statistics on Russian payments that are made through the Clearing House Interbank Payments System (“CHIPS”)² to give you a sense of the scale of Russian financial activity as it intersects with U.S. payment systems.

In presenting these issues we note that broad sanctions against various sectors of the Russian economy could affect a broad range of operations of U.S. financial institutions, and we understand that other trade associations and individual institutions have been holding discussions with OFAC and other government agencies on these matters. We have confined this letter to a discussion of some of the issues that would likely arise from the blocking or interruption of payment flows. We also note that our suggestions for relief relate to transactions that are already open on the day that

¹ Established in 1853, The Clearing House is the nation’s oldest banking association and payments company. It is owned by the world’s largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Association is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs, and white papers—the interests of its member banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the United States.

² CHIPS is a funds-transfer system operated by The Clearing House Payments Company L.L.C., an affiliate of The Clearing House Association. See note 1, above.

sanctions take effect—we do not request permission to continue to open new transactions with sanctioned parties after the effective date.

POTENTIAL ADVERSE EFFECTS OF UKRAINE-RELATED SANCTIONS AGAINST RUSSIAN PARTIES

1. Transactions that Have Been Partially Completed

Many transactions consist of two or more reciprocal parts that do not take place simultaneously. The clearest example is a foreign-exchange transaction that is not eligible for netting through CLS Bank International or similar financial market utilities. In these cases, the party selling rubles in exchange for dollars would deliver the rubles to its counterparty through the ruble clearing system in Moscow during business hours in Moscow, and would receive dollars through CHIPS, Fedwire, or a U.S. clearing bank during the banking day in New York. As the time in New York is eight hours behind the time in Moscow, there is the potential for a significant delay between the time a party to a foreign-exchange transaction must pay in rubles and the time it gets paid in dollars.

If sanctions against the party that has to pay dollars are announced intraday, the sanctioned person's counterparty would not be able to receive the dollars even though it had already performed its part of the agreement by delivering rubles. In these situations, the sanctioned party would suffer no harm because it has already been paid; but its counterparty, which has not been sanctioned, would not be able to obtain payment because the sanctioned party's payments have been blocked. The inequity of this is obvious.

While it has been argued that the payment has only been delayed, not prevented, OFAC sanctions often last for decades, and a payment delayed for decades is the effective equivalent of a payment that never gets made. There is also no assurance that when sanctions are lifted the payment will be made as originally contemplated. After so much time, it will probably require some investigation to determine who should be paid, and the blocked funds could be subject to litigation.³ Finally, there is the possibility that the sanctioned party will indeed benefit from the sanctions' operation in that it will retain the economic benefit of continuing control of funds it had received while deferring payment of its obligation until the operative sanctions have been repealed.

³ See, e.g., *Bank of New York v. Norilsk Nickel*, 789 N.Y.S.2d 95 (N.Y. App. Div. 2004), where the court resolved a dispute over the "ownership of the funds" after OFAC sanctions were lifted by misinterpreting Article 4A of the Uniform Commercial Code and ordering the bank to pay the wrong party.

We therefore suggest that in crafting sanctions regulations, OFAC either (i) allow for continued payment in dollars by sanctioned parties to non-sanctioned parties, (ii) allow the non-sanctioned parties to pursue remedies against the sanctioned parties (see section 2, below), or (iii) announce sanctions regulations during a window when non-sanctioned parties would not be vulnerable to these loss exposures (see section 3, below).

2. Existing Extensions of Credit

In connection with extensions of credit (including loans, trade finance, and derivatives) made prior to imposition of sanctions, sanctioned obligors have incurred obligations to repay or reimburse non-sanctioned lenders in the future. These credit exposures include outstanding loans payable by the obligors on scheduled repayment dates and letter-of-credit drawings previously paid by U.S. banks subject to reimbursement from the sanctioned obligors on future maturity dates. These extensions of credit are of varying maturities and can include long-term exposures. Issues can also arise when parties other than the obligor are sanctioned (for example, the issuer of the securities underlying a securities-lending arrangement).

If sanctions require blocking of any payments received from these obligors, U.S. banks and other non-sanctioned lenders would be unable to apply the payments they receive to the outstanding obligations. They would also be prevented from exercising rights to take possession and dispose of any collateral (including cash collateral or accounts) that the sanctioned parties had previously pledged to secure their obligations, and they would also be prevented from exercising their set-off rights. Moreover, at least in the case where the sanctioned account party has posted collateral, it has essentially already have paid for the credit, and freezing this collateral in no way affects the sanctioned borrower (which considers the credit paid), but only damages the non-sanctioned lender. The result would be an adverse effect on non-sanctioned lenders—the majority of which may be U.S. banks—rather than on the intended targets, who would have already received the benefit of the extensions of credit.

In some cases non-sanctioned lenders will have relied on credit support from third parties such as export-credit agencies or multilateral agencies, private insurers, and other non-sanctioned participant banks. These parties agreed to make payments in the event of a default by the obligor. However, imposition of blocking sanctions may preclude the lenders from making claims under such credit support within applicable expiry or termination dates, causing the loss of the credit protection. The lenders may also be precluded from exercising their remedies against the sanctioned obligors and transferring their interests in the obligations to credit-support providers in a timely fashion. For example in the case of some guaranties, the guaranty will not be paid unless the lender can transfer the loan to the guarantor, which would be prohibited by the sanctions unless a license is issued. As a result the lender would not satisfy the

conditions for asserting or receiving payment of its claims even though the credit-support provider is a non-sanctioned party.

To alleviate this concern, we urge OFAC to allow a non-sanctioned lender to obtain repayment of any loan or other credit in any transaction involving a sanctioned party (including where the sanctioned party's involvement is as an issuer of securities that make up the property on loan or which comprise the collateral pledged in support of such loan) and to exercise whatever remedies it may have against the borrower, including exercising set-off rights, disposing of collateral, or transferring obligations to guarantors or other credit-support providers.

3. Time for Announcing Sanctions

Because of the importance of the U.S. dollar in global trade and finance, U.S. markets and market infrastructures have in the past few years expanded their operating hours to allow dollar payments to be made during the business day throughout the world. The banking day for the Fedwire funds-transfer service, which is operated by the Federal Reserve Banks, begins at 9:00 P.M.⁴ and ends at 6:30 P.M. the following day. Similarly, CHIPS begins its business day at 9:00 P.M. and closes by 5:30 P.M.

Because of the difficulty of arresting transactions that are already in flight and the potential consequences to non-sanctioned parties if one side of a transaction is performed but the other side is blocked, we recommend that sanctions become effective during the times that U.S. market infrastructures are closed, i.e., between 6:30 P.M. and 9:00 P.M.

VALUE OF RUSSIAN TRANSACTIONS IN U.S. MARKETS

In order to get some sense of the size of the financial risk that could be posed by imposing sanctions on the Russian financial sector, The Clearing House surveyed CHIPS payment messages for the period January 1, 2014 through May 31, 2014 to identify funds transfers that included a Russian party. This involved looking for CHIPS UIDs⁵ and SWIFT BICs⁶ associated with Russian addresses in the various send and receive party

⁴ All times are U.S. eastern time.

⁵ A CHIPS UID (Universal Identification Number) is an identifier that CHIPS assigns to parties that are listed in the CHPS Name and Address File. CHIPS participants provide the name, address, and account number of their business customers for which the participants regularly send or receive CHIPS payment messages to the Name and Address File. Using a CHIPS UID results in greater straight-through processing of funds transfers.

⁶ A SWIFT BIC is a bank identification code assigned by the Society for Worldwide Interbank Financial Telecommunication.

fields of the CHIPS payment message format.⁷ Where these identifiers were not available we looked for Russian addresses in the payment messages. These search methods are necessarily approximate as the addresses found in the payment messages may identify the Russian offices of non-Russian parties, and some payment messages may lack names and addresses for any party. Nonetheless, they are our best estimate of CHIPS payment messages involving a Russian party.

For the period January 1, 2014 through May 31, 2014, CHIPS processed a daily average of 5,233 payment messages with a daily average value of \$27.3 billion with a Russian party in one of the send party fields, and a daily average of 4,715 payment messages with a daily average value of \$26.8 billion with a Russian party in one of the receive party fields. These figures represent between 1 and 2% of CHIPS volume.⁸ We assume that much of the Russian payment traffic is from one Russian party to another, so that there is likely a good deal of overlap in the send and receive figures.

These figures are CHIPS volume only; they do not include Fedwire.⁹ Moreover, very large global banks maintain extensive correspondent networks and can complete a large percentage of their funds transfers on their own books without using any funds-transfer networks. The value of these book transfers often exceeds the value of CHIPS payment messages by a considerable amount. These payments cannot be captured by a survey of CHIPS payment messages. The figures above therefore likely represent only a small portion of the total dollar payment flows involving Russian parties.

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⁷ The *send party fields* are the fields in the CHIPS format that are assigned to the CHIPS sending participant and the prior parties (originator, originator's bank, instructing bank) in the funds transfer. The *receive party fields* are the fields in the CHIPS format that are assigned to the CHIPS receiving participant and the subsequent parties (intermediary bank, beneficiary's bank, and beneficiary) in the funds transfer. As no Russian banks are CHIPS participants, Russian identifiers would not appear in the sending participant or receiving participant fields.

⁸ During the same period, CHIPS volume was a daily average of 423,044 payment messages with a daily average value of \$1.6 trillion. Russian transactions were 1.2% of send volume, 1.7% of send value, 1.1% of receive volume, and 1.7% of receive value.

⁹ As Fedwire volume is heavily weighted toward U.S. domestic payments, it is likely that Russian payments will be only a very small percentage of Fedwire payment orders.

We hope this information is useful. If you have any questions, please contact me at 212-612-9234 or joe.alexander@theclearinghouse.org.

Very truly yours,

A handwritten signature in black ink, appearing to read "Joseph R. Alexander", with a long horizontal flourish extending to the right.

Joseph R. Alexander
Senior Vice President, Deputy
General Counsel, and Secretary

cc: Barbara Hammerle, Esq., Deputy Director