Sanctions and the transport sector

How international transport providers have responded to sanctions against Russia and what comes next.

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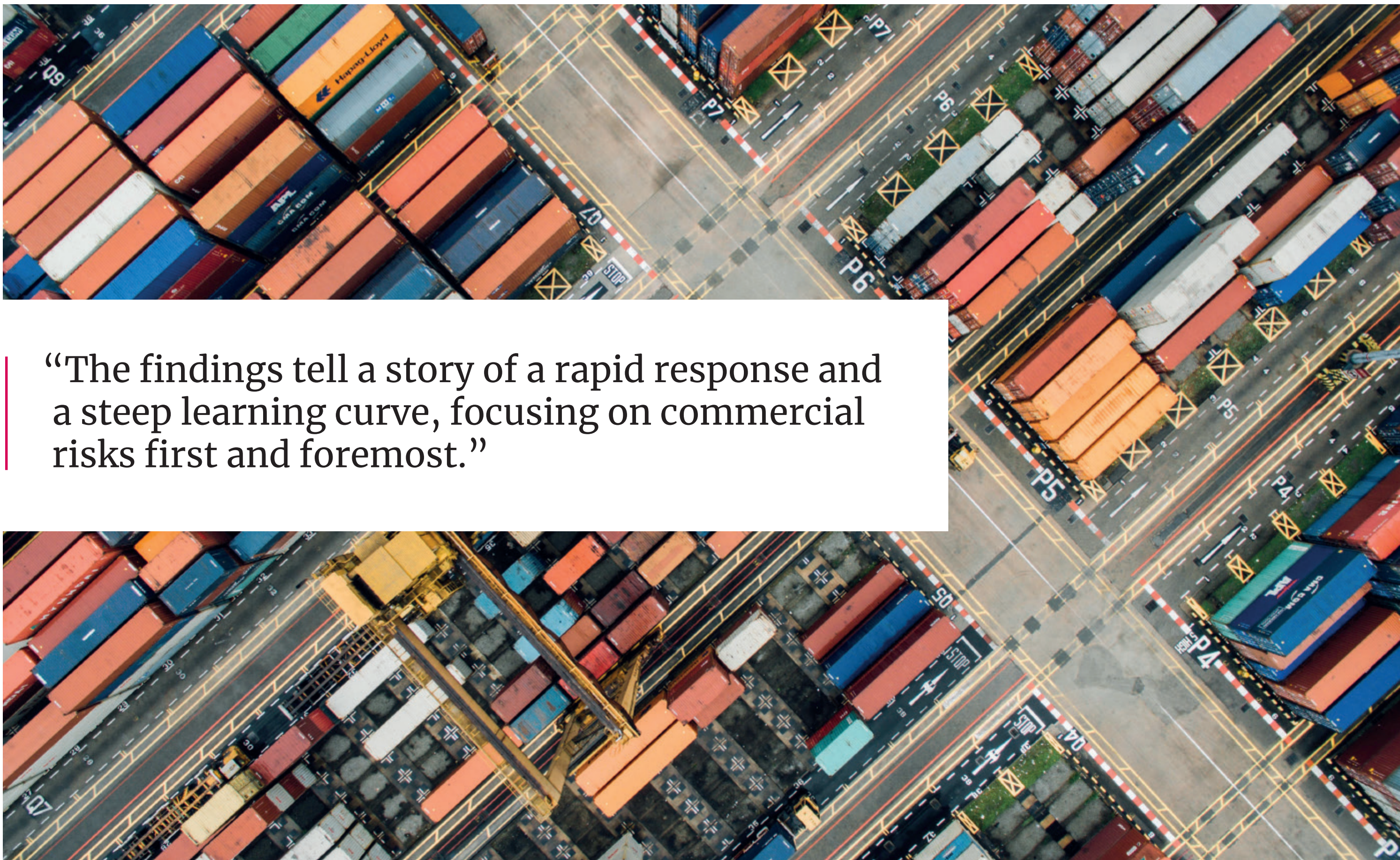

> "The findings tell a story of a rapid response and a steep learning curve, focusing on commercial risks first and foremost."

Welcome

When Russia invaded Ukraine in February 2022, the USA, the EU and a swathe of other countries quickly introduced or significantly expanded sanctions regimes to target Russia's President, Vladimir Putin, and his inner circle and cut off selected Russian banks from international financial markets.

For the transport services industry, the need to terminate contracts with the Russian state, cease deliveries and shipments to and from Russia, and step back from dealings with Russian financiers and investors has had a profound impact.

As the sanctions landscape has continued to evolve, the need to adopt appropriate measures to both ensure compliance with sanctions and mitigate risks arising from the fast-moving regulatory landscape has been pressing.

Having passed the one year anniversary of Russia's invasion of Ukraine, we decided to investigate and report on how confident businesses in the transport industry are in their ability to cope with the sanctions environment as it stands today. We wanted to find out more about what steps companies have taken – and are planning to take – to ensure compliance and mitigate risk, and further our understanding of the areas of ongoing concern.

For this report, we surveyed senior decision-makers in the transport sector – across rail, road, sea, air and logistics – from large businesses operating all around the world.

The findings tell a story of a rapid response and a steep learning curve, focusing on commercial risks first and foremost.

This year, we expect legal risks to move up the agenda as enforcement action and litigation in response to the sanctions landscape become a feature of the market. Companies operating on an international stage must now build a long-term response in anticipation of sanctions becoming a greater feature of business going forward.

Sanctions play a critical role in maintaining international peace and security. Whilst this report focuses on the conflict in Ukraine, sanctions are used in many countries to help change the behaviour of those individuals and regimes responsible for conflict.

Should you wish to discuss any of the issues raised over the following pages, please do not hesitate to get in touch.

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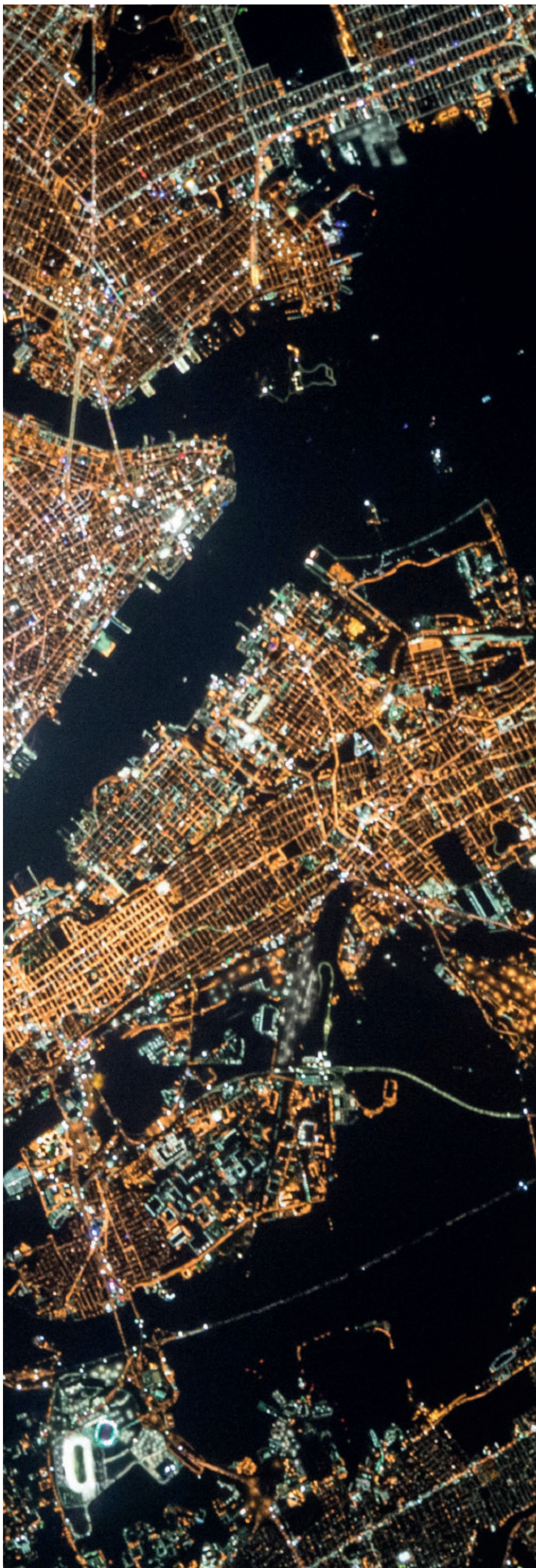


Key findings

Transport providers moved quickly to address sanctions against Russia.

Since sanctions were introduced against Russia in the wake of its invasion of Ukraine, international transport operators have quickly cut back their dealings with the country.

76% have terminated all contracts that could benefit the Russian state

76% have ceased all deliveries to and from Russia

Transport companies are focused on the remaining commercial risks...

Executives in the sector are alert to the future risks that sanctions against Russia still pose to their sales and profits. These include:

64% increased insurance costs

60% loss of business with Russian customers

50% shortfall of investment from Russian banks or individuals

Sanctions call for a long-term response.

The international community's unprecedented success in coordinating sanctions against Russia suggest they may be deployed more widely and frequently in future.

64% expect international sanctions to be more common in future

56% believe that a world with more sanctions will be riskier for their business

Transport providers have already paid a price for this rapid response.

Most transport providers have lost business and suffered increased compliance costs as a result of these sanctions.

58% have experienced increased compliance costs due to Russian sanctions

52% have lost business with Russian customers

...but may underestimate the legal risks.

Both enforcement actions brought by regulators and litigation from customers are expected to increase this year, but so far survey respondents are less concerned about legal risks.

only 6% fear a custodial sentence for a director for a sanctions breach

Transport providers continue to build their sanctions capabilities.

The capability to respond to international sanctions is still a work in progress for most transport businesses, and most expect to call on legal counsel in future.

68% plan to seek legal counsel on sanctions against Russia

52% will seek guidance from regulators

Chapter 1: Rapid response

Transport providers moved quickly to accommodate sanctions against Russia, but it has been a steep learning curve and there is more work to do.

In the past year, transport companies have moved quickly in response to Russian sanctions. Three quarters of those we surveyed for this report have terminated contracts that could benefit the Russian state, and the same proportion have ceased deliveries to and from Russia. Six out of ten have ceased all interactions with Russian financial institutions and investors.

This has not been painless:

58% of survey respondents have seen compliance costs grow due to Russian sanctions.

And around half have lost business with Russian customers (52%) or business with other customers that relies on Russian routes or entities (48%).

While most respondents are now confident in their organisation's ability to manage sanctions risks, it has been a steep learning curve.

One of the biggest challenges we have heard from clients has been dealing with the pace of change. As sanctions rules have evolved to cover additional entities, individuals and sectors of the economy, it has been hard for companies to keep up.

The scale of the sanctions has been overwhelming to some. Sanctions were not previously on the radar for many companies, and getting policies and procedures up and running has been a baptism of fire.

While there is now broad recognition of the need for comprehensive due diligence and risk management to ensure compliance, not all companies had access to the right resources when a new wave of sanctions against Russia was introduced last year.

Our survey shows that less than a third were receiving regular updates on sanctions from governments and regulatory bodies before sanctions were imposed, for example. And fewer than one in 10 were assessing individual transactions for sanctions compliance risk.

The events of the past year have required a significant shift: 60% of respondents have started to regularly refresh their sanctioned entity lists and nearly half now source regular sanctions updates from regulators.

Still, there is more to be done: 50% of respondents have yet to assess the beneficial ownership of suppliers and customers, for example, and 46% are not looking into the location of suppliers and customers or requiring suppliers to confirm sanctions compliance.

> "In the rapidly evolving sanctions landscape, and taking account of the severe penalties for non-compliance, it is essential that businesses are fully aware of their sanctions obligations and how to effectively implement robust procedures to demonstrate compliance. Establishing ownership of companies can often be a challenging task, particularly as entities can often use complex structures to transact business undetected. Businesses should ensure that thorough checks are completed through respected databases, that these checks are documented and that they are regularly reviewed. Businesses should seek legal guidance if there is any doubt in order to ensure full compliance with their obligations."
>
> Radhika Ruparelia, Senior Associate, DWF - London

We know that engaging in transactions with sanctioned counterparties will result in significant financial, reputational and civil liabilities this year, so companies need to get this right.

But it is no longer enough just to comprehend the broad parameters of what is required and be seen to be taking steps; regulators will now expect companies to be on top of the details.

The repercussions of failing to comply are potentially severe, including significant penalties and even imprisonment for directors found personally liable, and we anticipate enforcement action ramping up through the year ahead.

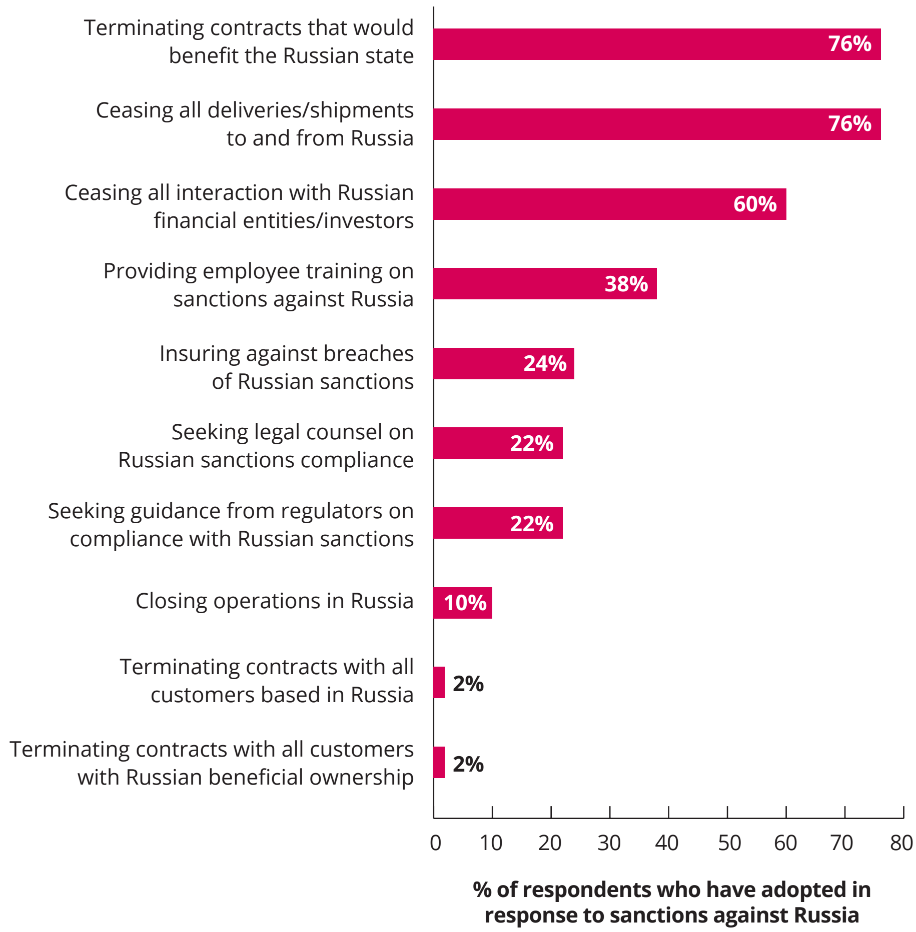
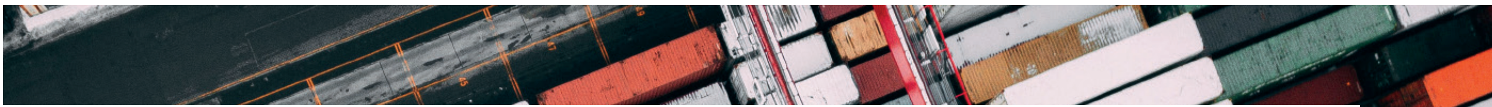


Chart 1 Transport providers moved quickly to cut ties with Russia last year.



"New legislative changes have brought an increased risk of enforcement action for breaches of the UK financial sanctions regime.

The Economic Crime (Transparency and Enforcement) Act 2022 introduced a new strict civil liability test for imposing monetary penalties for breaches of the financial sanctions regime, thereby removing the previous requirement for OFSI [the Office of Financial Sanctions Implementation] to prove that a person had knowledge or reasonable cause to suspect that they were in breach of financial sanctions.

This change will undoubtedly strengthen OFSI's ability to take appropriate enforcement action against those that fail to ensure they are not dealing with sanctioned entities or adhere to their financial sanctions obligations."

Euros Jones, Partner, DWF - London

Chapter 2: The risk landscape

Executives in the transport sector are keenly aware of the commercial risks posed by sanctions but may be underestimating the legal risks.

Transport companies have acted quickly to address Russian sanctions, but they also acknowledge that many risks remain. They are especially concerned about commercial risks, our survey reveals.

The chief risks emerging from Russian sanctions are rising insurance costs and losing business with Russian customers, identified by 64% and 60% of respondents respectively. Another widespread concern, identified by half of respondents, is losing access to finance and investment from Russian banks and individuals subject to sanctions.

These concerns are well founded. Insurance costs for transport providers have already increased since the imposition of sanctions for various reasons, including heightened risk leading to higher premiums, fewer insurers in the market driving up prices, and an increased difficulty for providers to assess risk. And as we've seen, more than half have already lost business with Russian customers.

Further increases in compliance costs are not their biggest worry, but transport providers should be prepared for a growing compliance burden. There is talk among policymakers of expanding the measures already in place, and companies will need to be agile to accommodate new restrictions.

Companies may choose to mitigate compliance cost increases by scaling up their in-house sanctions capabilities, but skilled professionals are in scant supply and can therefore command sizeable salaries. An alternative is outsourcing, which can avoid the need for widespread upskilling within the company.

> "EU sanction packages are having a strong impact on European insurers. The consequence is that respondents have no commercial incentive to provide transport insurance to companies with business in the war territories even where trading would be allowed according to EU law and provisions. Further to purely financial risks, they fear serious reputational consequences that could arise in doing business with those territories.
>
> In this geopolitical context, it is very difficult, if not impossible, to arrange insurance cover where the brokers, find themselves in the same situation as the insurance companies."
>
> Alfredo Berritto, Counsel, DWF - Milan

Regulatory enforcement

Compared with these commercial risks, respondents are less concerned about the legal risks emerging from sanctions against Russia. Only around a quarter of respondents are worried about penalties they might incur for various sanctions breaches, for example, and just...

6% are concerned about the risk of custodial sentences for directors.

This may be because there has been little evidence of transport companies incurring penalties for sanctions failings so far. But penalties for breaches are likely to increase moving forward, for both individuals and firms, as the rules bed down and authorities look to discipline those failing to comply.

In the UK, the Office of Financial Sanctions Implementation (OFSI) can impose a monetary penalty if it is satisfied that a business has breached a prohibition or failed to comply with an obligation under sanctions rules. The scale of that fine can be the greater of either £1 million or half of the estimated value of the funds or economic resources secured because of the breach.

In 2020, the OFSI hit Standard Chartered Bank with what was then a record fine of £20.4 million for loans that the bank made to Russian financial institutions in violation of the EU's sanction regime at the time. We anticipate OFSI enforcement stepping up considerably in the year ahead.

Furthermore, breaches of financial sanctions are criminal offences, so individual directors can be sentenced to up to seven years in jail if found guilty. Multinational businesses might face further liabilities from overseas regulators, and regulated professionals could face additional disciplinary actions from their professional bodies.

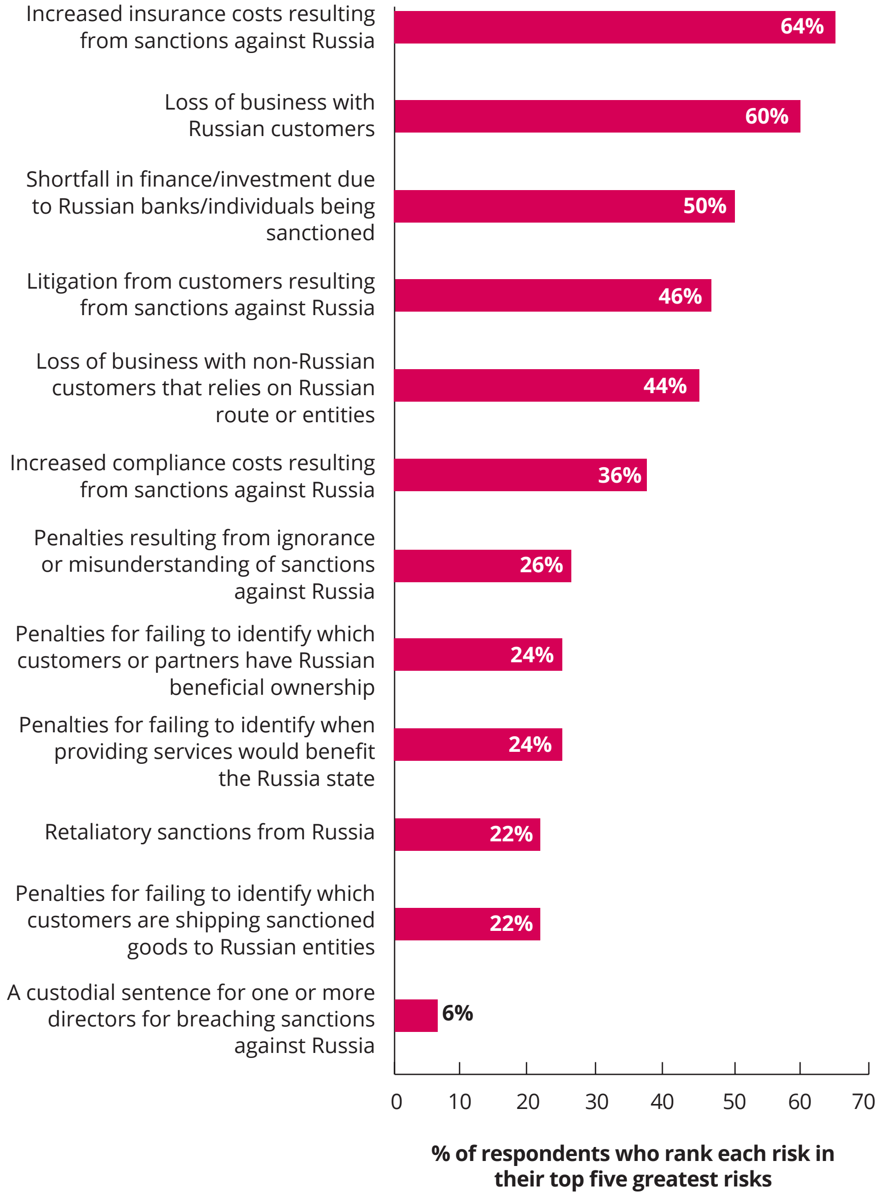


Chart 2 Transport industry executives are focused on the commercial risks arising from sanctions against Russia.

> "To navigate the matrix of sanctions and trade restrictions in China requires local knowledge, careful political analysis and, sometimes, imagination. In late 2020, a number of my shipping clients faced a ban on importing Australian coal into China (the ban later extended to wine, beef and lobsters) following hostilities between Canberra and Beijing. Vessels loaded with Australian coal were idle outside ports in northern China for months while winter was looming, and the sea became frozen. The ongoing sanctions on Russia and the renewed Sino-Russian relationship will be a sensitive yet challenging topic when it comes to trading in China."
>
> Anthony Woo, Partner, Hauzen (DWF Affiliate Firm, Hong Kong)

Litigation risks

Transport providers are more alert to litigation risk: 46% consider litigation from customers arising from sanctions against Russia to be one of their gravest risks. And one third have already experienced this.

In many cases, transport providers have been forced to breach contracts with commercial partners because sanctions rules forbid either the transportation of goods or involvement with certain individuals or products.

This led to a wave of breach-of-contract claims against transport providers that began at the start of 2022. And this looks set to escalate as commercial partners feel the impact of losses and seek restitution.

Defending such actions will often mean turning to the legal concepts of force majeure or frustration, both of which can be complex to navigate and are dependent on the specific terms of the original agreement.

Looking to the future, transport businesses will want to review the terms on which they are entering into commercial arrangements through a sanctions lens, so that they are not forced to breach commitments should more restrictions be imposed.

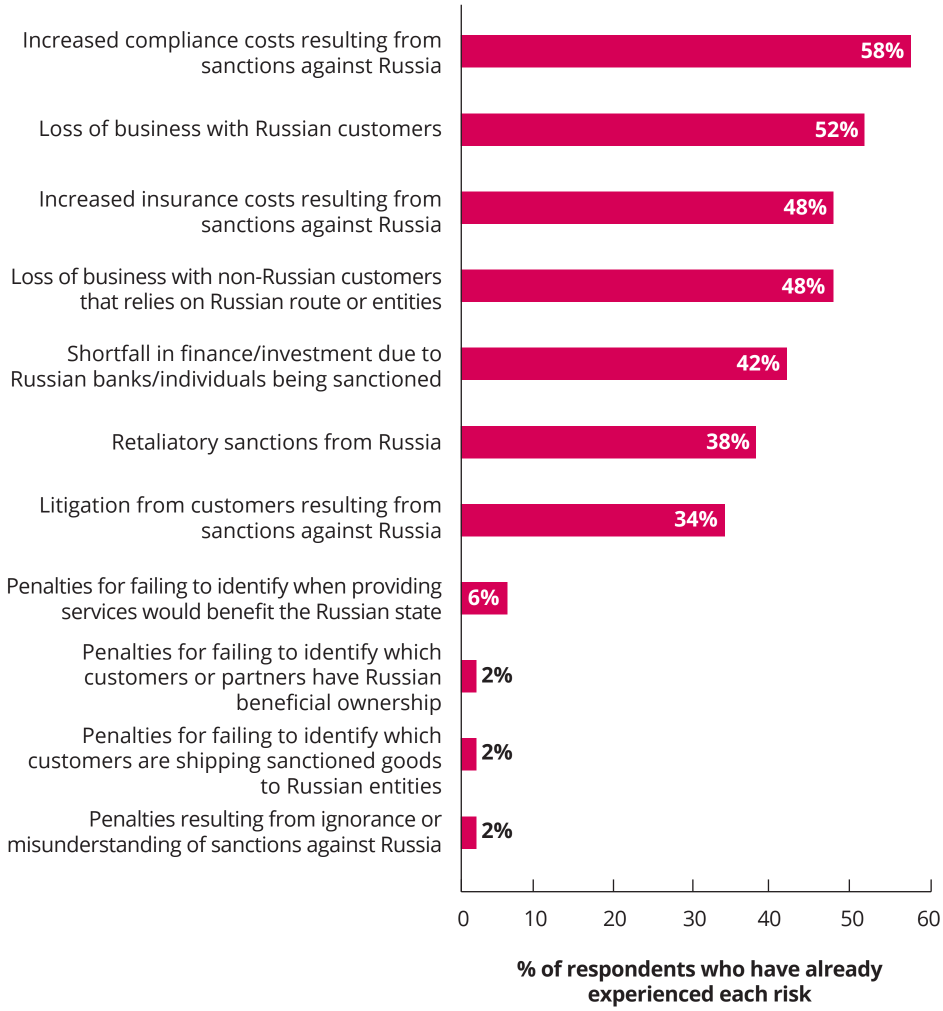


Chart 3 A third of respondents have already encountered litigation from customers resulting from sanctions against Russia.

Chapter 3: The long term

International sanctions are likely to become more common in future, calling for a long-term response.

Despite the costs that many have already incurred, only one quarter of our survey respondents agree that sanctions against Russia have already disrupted their organisation's transport services business.

This might reflect respondents' limited exposure to the Russian market. But it may also be that the full effect of the sanctions introduced in 2022 are yet to be felt, as enforcement has so far been limited.

What is more, it is reasonable to expect that the scope of the current measures will be increased, with enhanced targeting of financial institutions and expanded sectoral restrictions in areas such as energy being discussed.

The sanctions against Russia arising out of the invasion of Ukraine are broadly judged to have been effective. While Russia's economy seemed to be holding up better than expected at first, with the IMF forecasting a drop in GDP of just 3% for 2022, this decline now appears to be accelerating, according to data from the country's central bank. Newly expanded sanctions on Russian oil exports are likely to add to the pressure, according to a December 2022 report from the US Congressional Research Service.

It is therefore likely that we will see greater use of sanctions by the international community moving forward in response to rogue states.

Two thirds of surveyed transport companies expect international sanctions to be a more common occurrence in the future.

56% recognise that a world with more international sanctions will be riskier for their organisation.

If they are right, transport companies will need to build a long-term response to sanctions.

Awareness and agility

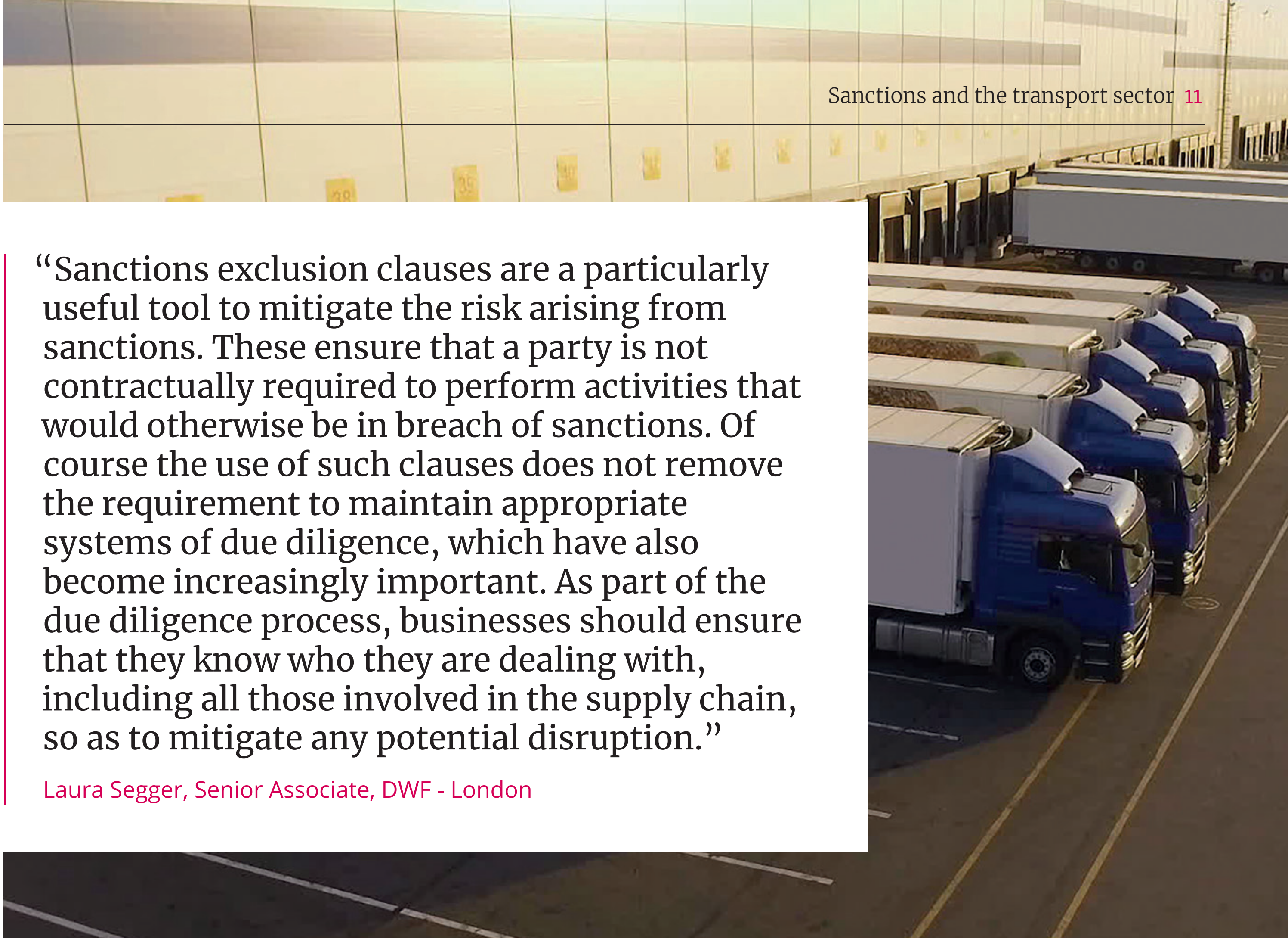
The transport industry learned in 2022 that sanction regimes are flexible, versatile and have the potential to take on an energy of their own, spreading their tentacles in many different directions to capture individuals, transactions, companies or sectors with often limited notice.

Businesses must therefore be agile, capable of anticipating what might come next and understanding how that will impact their day-to-day business operations.

That will require a focus on building knowhow within the organisation, beefing up compliance capabilities as a route towards keeping the business informed, and implementing streamlined policies and procedures to ensure sanctions updates are circulated and acted upon promptly.

Survey respondents certainly plan to continue building their sanctions compliance capabilities in future: 68% plan to seek legal counsel on sanctions compliance. Other planned measures include seeking guidance from regulators on compliance (52%) and providing employee training on sanctions (50%).

To better monitor compliance, 44% plan to introduce assessments of the beneficial ownership of suppliers and customers, 40% plan to assess the location of suppliers and customers, and 38% will assess individual transactions for sanctions compliance risks.



> "Sanctions exclusion clauses are a particularly useful tool to mitigate the risk arising from sanctions. These ensure that a party is not contractually required to perform activities that would otherwise be in breach of sanctions. Of course the use of such clauses does not remove the requirement to maintain appropriate systems of due diligence, which have also become increasingly important. As part of the due diligence process, businesses should ensure that they know who they are dealing with, including all those involved in the supply chain, so as to mitigate any potential disruption."
>
> Laura Segger, Senior Associate, DWF - London

All of these measures require coordination, and a useful approach is to set up a sanctions committee within the organisation to meet regularly, keep abreast of developments and cascade information throughout the business.

Another advisable action is a wholesale review of commercial contracts, looking at termination clauses, choice of law and jurisdiction clauses, and potentially adding clauses to new contracts that allow them to be terminated or suspended if further sanctions are imposed.

The sanctions landscape is fast-evolving and requires companies to be alert and aware: being in good shape today may not be enough to address tomorrow's challenges.

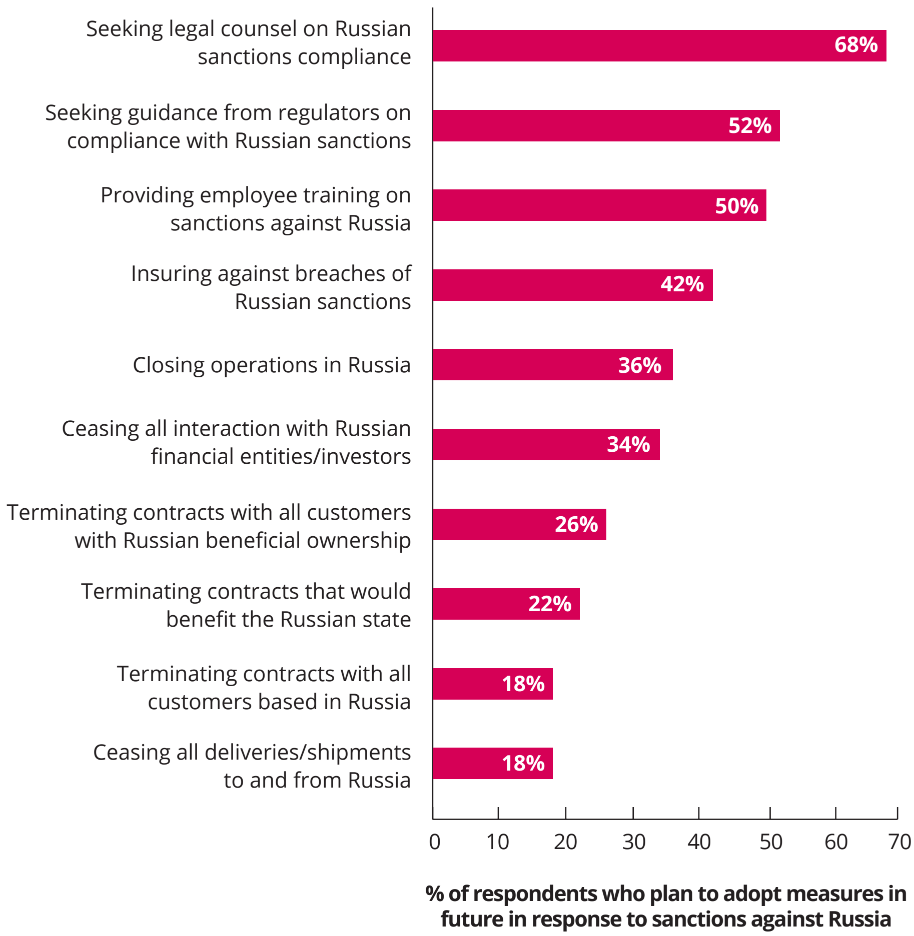


Chart 4 Transport providers are still developing their capabilities to address sanctions.

Recommendations

Establish a sanctions committee

Assembling a group of experienced individuals from across the business on a regular basis can help track sanctions developments, disseminate updates and coordinate the corporate response.

Invest in compliance resources

Whether expanding in-house capabilities or embedding relationships with external service providers, now is the time to bolster resources to better monitor and address compliance.

Review commercial contracts

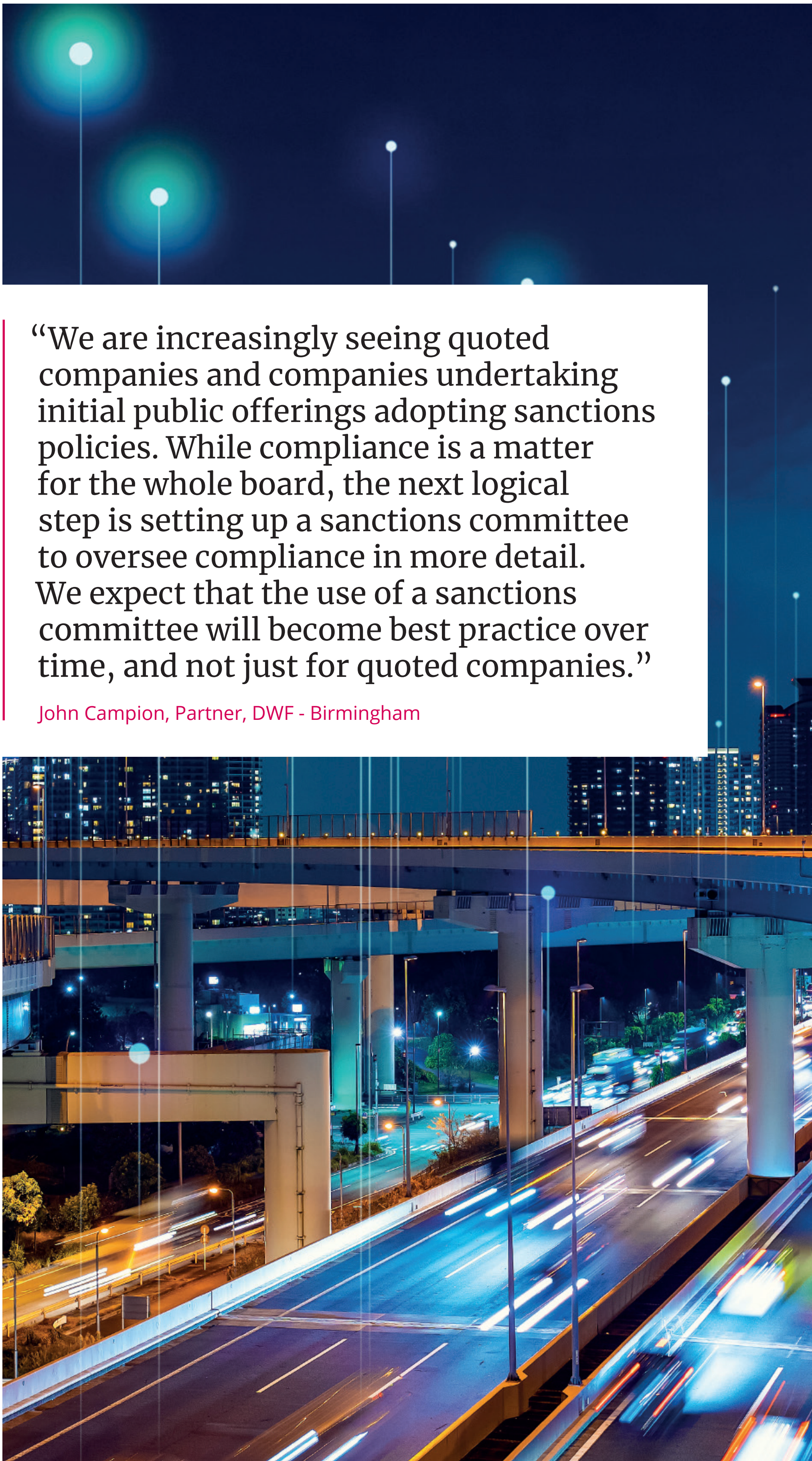
A wide-ranging review should identify current exposures with a view to being proactive and consider new terms for contracts to better protect the business from future sanctions risks.

Start assessing beneficial ownership

Businesses need to put in place the relevant policies and procedures to ensure robust and up-to-date information is kept on corporate partners in order to guarantee transactions do not contravene sanctions rules.

Seek regular updates from legal counsel

As sanctions evolve to touch more individuals, entities, subsidiaries and sectors, companies must establish procedures to ensure they are receiving regular legal updates to monitor and maintain compliance.

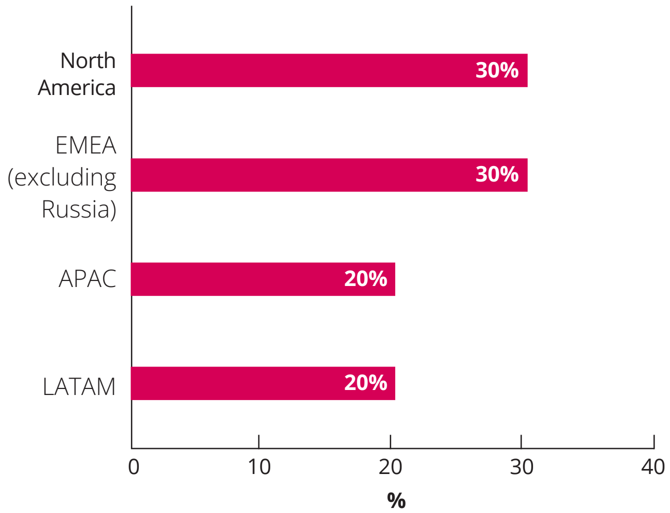


> "We are increasingly seeing quoted companies and companies undertaking initial public offerings adopting sanctions policies. While compliance is a matter for the whole board, the next logical step is setting up a sanctions committee to oversee compliance in more detail. We expect that the use of a sanctions committee will become best practice over time, and not just for quoted companies."

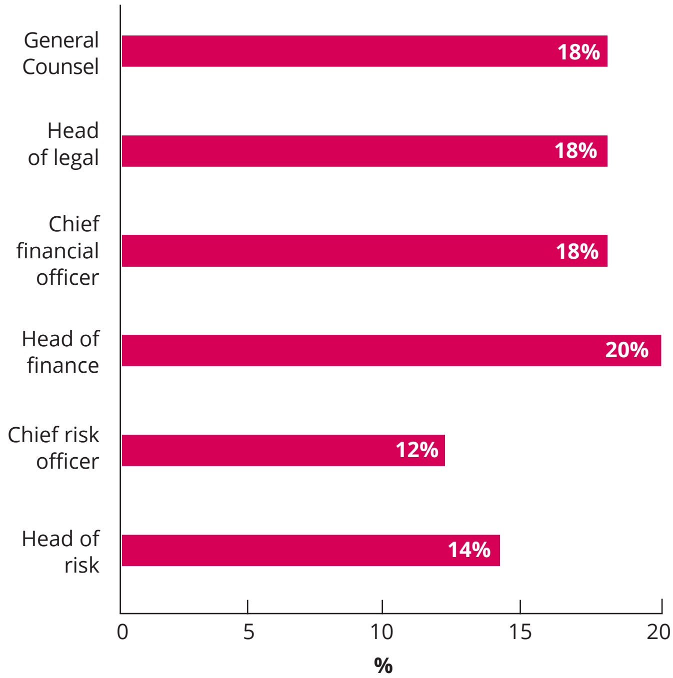
John Campion, Partner, DWF - Birmingham

Appendix: Methodology

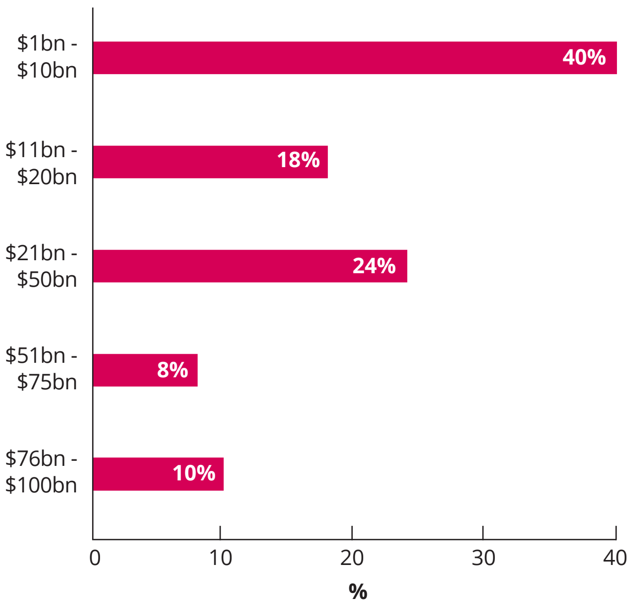
This report is based on a global survey of 50 senior executives from international transport providers. Respondents were screened via telephone then completed an online questionnaire. The profile of respondents is as follows.



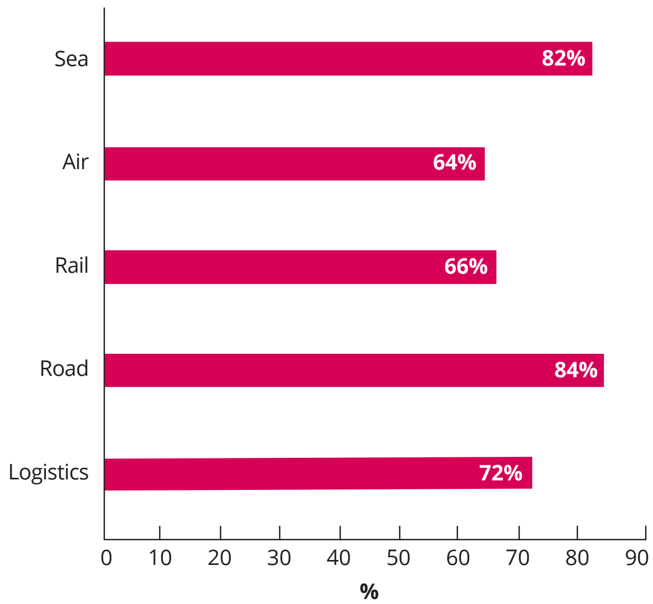
Location



Job title



Company size (annual revenue)



Transport subsectors

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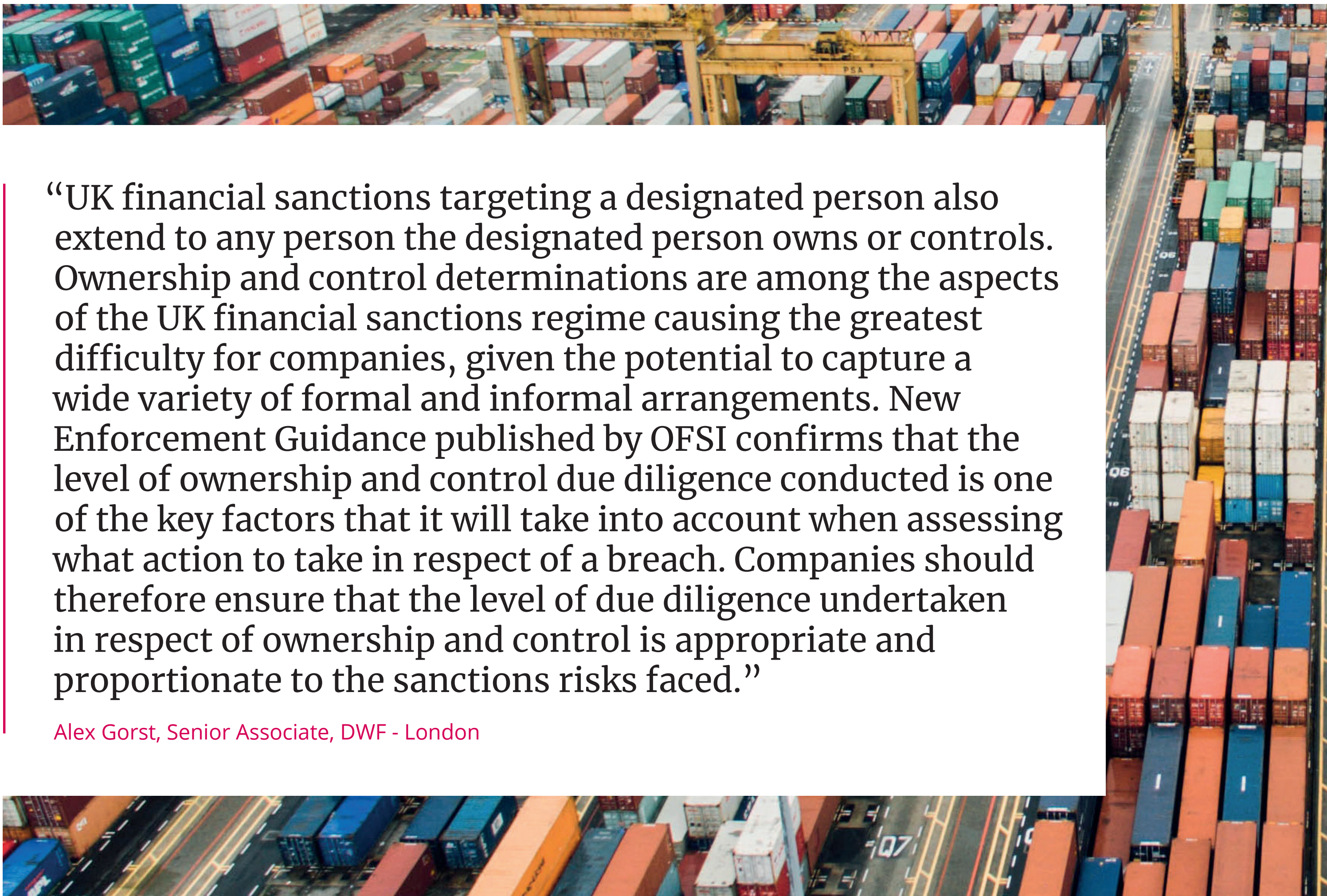

"UK financial sanctions targeting a designated person also extend to any person the designated person owns or controls. Ownership and control determinations are among the aspects of the UK financial sanctions regime causing the greatest difficulty for companies, given the potential to capture a wide variety of formal and informal arrangements. New Enforcement Guidance published by OFSI confirms that the level of ownership and control due diligence conducted is one of the key factors that it will take into account when assessing what action to take in respect of a breach. Companies should therefore ensure that the level of due diligence undertaken in respect of ownership and control is appropriate and proportionate to the sanctions risks faced."

Alex Gorst, Senior Associate, DWF - London

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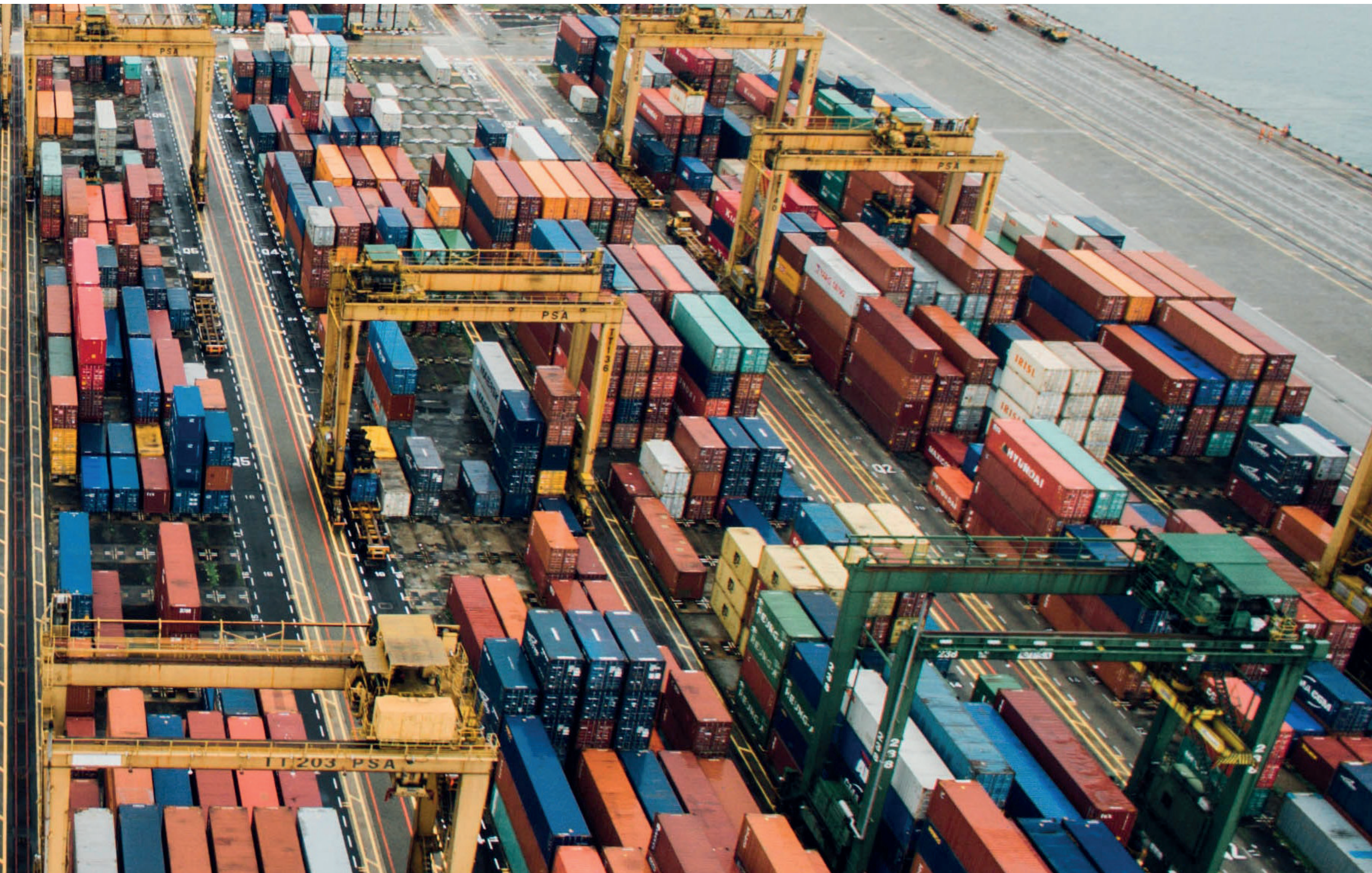

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