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Collateral damage – US sanctions target the secondary market in Russian stocks and bonds

BY JUDITH ALISON LEE

In June 2022, the Office of Foreign Asset Control (OFAC), the agency within the US Treasury Department that administers economic sanctions, took the unprecedented step of prohibiting US persons from purchasing Russian debt and equity securities on secondary markets. The ban sent the value of Russian corporate and government bonds tumbling and brought trading in a major emerging market asset class to a near halt.

OFAC's move reflects the extreme pressure that the Biden administration has placed on the Russian economy in response to Russia's invasion of Ukraine. The US has sanctioned more than a thousand individuals and entities, imposing, in the words of one Treasury official, "unprecedented sanctions and financial measures to cut Russia off from the international financial system".

Yet OFAC's investment ban is also an unprecedented restriction on investments in the world's eleventh largest economy. It goes beyond targeting the flow of capital into Russia, prohibiting transactions between holders of Russian debt who are neither Russian nor sanctioned. It also targets a major emerging market in which US pension funds have made significant investments. Even more striking, OFAC banned these transactions through a guidance document rather than by issuing a regulation that would have the force of law.

This article discusses why OFAC barred US investors from purchasing Russian stocks and bonds on secondary markets and the ban's implications for investors and financials markets.

Prohibition on 'new investment' in Russia

In April 2022, president Joseph Biden issued an executive order prohibiting US companies and individuals from making new investments in the Russian economy. The ban followed an earlier prohibition on new investment in the Russian energy sector and other sectors specified by the treasury secretary. These orders also prohibited US persons from approving, financing, facilitating or guaranteeing new investments in Russia.

Most observers concluded that the administration's prohibition on new investment allowed the purchase of Russian stocks and bonds on secondary markets. Janet Yellen, treasury secretary, described the ban as "further restrict[ing] Putin's ability to fund and supply his war" and the resale of securities does not provide funding to the issuer of those securities. OFAC had also issued earlier guidance that an executive order banning transactions with the Russian central bank, finance ministry and sovereign wealth fund did not bar trading of these entities' securities on secondary markets.

In early June 2022, however, OFAC updated the 'frequently asked questions' (FAQ) section of its website to indicate that the administration's executive orders banning new investment also prohibit purchases of previously issued debt and equity securities trading on secondary markets. The agency also advised that US persons are prohibited from approving, financing, facilitating or guaranteeing such secondary market transactions for non-US persons.

OFAC stopped short, however, of severing American and Russian capital markets. US individuals and entities can continue to hold Russian stocks and bonds and may maintain investments made before the ban on new investment went into effect. They are also permitted to divest their Russian holdings provided those entities are not sanctioned and the buyer is not a US person.

Surprising development

OFAC's decision to ban secondary market transactions of Russian debt and equity surprised many observers because it diverged sharply from the agency's usual practice. OFAC rarely bans US individuals and entities from purchasing the securities of non-sanctioned entities.

It was also unusual for OFAC to announce a policy with significant economic implications through a FAQ. When OFAC has banned such transactions, it has done so by defining 'new investment' in formal regulations. OFAC also frequently issues general licences to minimise unintended consequences to third parties. Yet its ban on secondary market transactions will reduce the value of many US pension funds and emerging market funds, harming public sector employees and those saving for retirement.

OFAC's ban on secondary market transactions was also anomalous because Russia is a major economy, which the US has not comprehensively sanctioned as it has North Korea and Iran. And although OFAC previously banned US persons from purchasing Burmese existing equity, it stopped short of prohibiting secondary market transactions of Burmese bonds. Russia also has a far larger economy than Burma, and Russian debt is a leading emerging market asset class.

OFAC has not publicly explained its rationale for its unprecedented ban on US purchases of Russian stocks and bonds on secondary markets. In announcing its ban on new investment in Russia, the White House declared that sanctions would wipe out the last 15 years of the country's economic gains, eliminating its status as a major economy.

It also stressed that sanctions had contributed to Russia's "economic, financial and technological isolation" and that its investment ban would build on the decision of more than 600 companies to withdraw from Russia. Although buying stocks and bonds on the secondary market does not fund Russian businesses or the Russian government, prohibiting such transactions might make many investors even more nervous about potential exposure to the Russian economy.

OFAC may also have been reacting to the increase in secondary market transactions in Russian bonds. Investors, including many hedge funds specialising in distressed assets, saw the fall in the Russian bond market that followed the invasion of Ukraine as an opportunity, pushing trading volumes to a two-year high. Like some members of Congress, OFAC may be concerned that these trades had "the potential to undermine US sanctions and fund Russia's human rights abuses in Ukraine". Even though Russian bond issuers receive little if any benefit from the resale of their bonds, the perception that some US investors were profiting from Russian aggression may have influenced OFAC's decision making.

Disrupting capital markets

Whatever OFAC's motivations in banning secondary market purchases of Russian bonds, the agency likely underestimated the collateral consequences of its guidance. US banks, which had served as market makers selling Russian bonds to their clients, withdrew from the market. And although non-US individuals and entities could continue to purchase Russian securities, the outsized role of American institutions and investors in the global financial system made it difficult for those in other countries to find buyers. As a result, the price of Russian government and corporate bonds fell precipitously and trading in Russian bonds ground to a halt.

Given the size of the Russian economy, the impact of these developments on pension funds and financial markets will likely be significant. Russian bonds are the world's fourth largest pool of emerging market assets, with Russian government and corporate debt amounting to $472bn at the start of the year. OFAC's ban appears to have hit pension funds, which hold trillions of dollars in retirement savings, particularly hard. Before Russia invaded Ukraine, pension funds globally invested about 1 percent of their assets in Russia. And although many pension funds have announced plans to divest from Russia, selling their holdings is difficult because many financial services firms are reluctant to deal in Russian securities.

OFAC's ban on purchases of Russian debt securities is likely to compound bond investors' losses as the Russian government and Russian companies are unable to make interest payments on dollar-denominated bonds because of US sanctions on the Russian central bank. Indeed, Pacific Investment Management Co., one of the world's largest fixed income funds, has warned the US Treasury that pension funds will face significant losses if fund managers are forced to write down their Russian holdings.

OFAC's guidance has also disrupted the market for credit default swaps (CDSs). Investors use CDSs to hedge against potential default. When a credit event occurs, such as Russia's recent failure to pay interest on its government bonds, an auction determines the amount that the CDS holder will receive.

Yet because the auction often involves the physical transfer of securities, sanctions make it illegal for US investors to participate. This has made it difficult to value CDSs, an issue that will likely grow in importance as more Russian corporate and government bonds go into default. As a result, OFAC's ban may unintentionally undermine confidence in CDSs as a hedge against emerging market uncertainty, denting investment in developing countries.

Implications

Russia is the largest economy ever sanctioned by the US and remains deeply integrated into global markets. Although the US has sanctioned more Russian individuals than those of any other country, it has not imposed comprehensive sanctions.

Yet the Biden administration has made no secret of its desire to isolate Russia economically and financially so long as the war in Ukraine continues. OFAC's ban on secondary market transactions underscores the agency's willingness to cut Russia off from capital markets, even when this would have significant collateral consequences for the US economy and emerging markets. And although OFAC could issue general licences to shield investors whose Russian interests do not support the invasion of Ukraine, investors should not expect that OFAC will prioritise their interests.

OFAC's ban on US purchases of Russian stocks and bonds has harmed pensions funds and disrupted capital markets. It serves as a cautionary tale for investors in the US and around the world that have lent Russian businesses and the Russian state billions of dollars. So long as Russia continues to resist sanctions, OFAC will impose restrictions designed to undermine the country's financial system.

Investors with exposure to Russia – even indirect exposure – cannot expect that OFAC will always fully consider the implications of its guidance for financial markets. They will therefore want to exercise extreme caution to ensure that they comply with current sanctions and that they understand their exposure to potential future restrictions. ■

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