



# SANCTIONS AGAINST IRAN: TRENDS AND EMERGING RISKS

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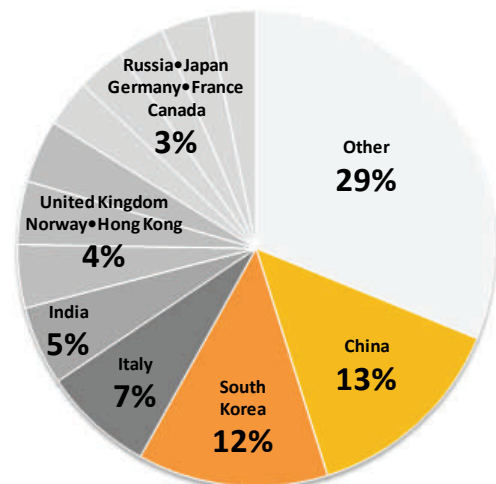
Corporate involvement in Iran has long faced restrictions, but 2010 saw a flurry of legislative activity globally against the Islamic republic, as diplomats endeavoured to pressure the country to cease its nuclear program and support for terrorism. Multilateral sanctions were implemented by the United Nations against elements suspected of involvement in Iran’s nuclear program, and broader sanctions were enacted by the United States (U.S.), the European Union (EU) and other countries in an attempt to isolate Iran and cut off sources of revenue. These regulations have far-reaching consequences for companies and investors across a range of industries, including energy, shipping, finance and insurance. Companies with any sort of activity in Iran are facing heightened regulatory scrutiny and reputational risk.

How companies react to this new regulatory environment is a reflection on their risk management and disclosure practices. Responsible investors will want to know about their holdings’ business activities in Iran. According to the Sustainalytics Iran Compliance Service, hundreds of globally traded equities have some sort of activity in Iran, potentially leaving them in violation of sanctions. Violations can carry significant punishment in terms of fines or restrictions on activity. In the past, the lax enforcement of sanctions may have allowed companies to ignore risks; however, today’s regulatory environment is considerably more vigilant. Investors should expect companies to disclose and manage these risks appropriately.

## Sanctions Against Oil and Gas Activities

The United Nations Security Council has not sanctioned Iran’s oil and gas industry, reportedly because of Chinese and Russian resistance. Nonetheless, the U.S. and its allies have targeted the development of Iran’s energy sector as a way to pressure the country, given Iranian reliance on imports of refined petroleum as well as its dependence on western oil and gas reserves.

Although the EU, Canada, Australia, South Korea and Japan have all prohibited new investments in the form of equipment, technology, and technical assistance to Iran's petroleum industry, it is the U.S.'s *Comprehensive Iran Sanctions Accountability, and Divestment Act of 2010* (CISADA) that goes the furthest. CISADA is extra-territorial; U.S. nationals have been prohibited from doing business in Iran for over a decade, but these sanctions target foreign companies and foreign subsidiaries of U.S. companies. Under the terms of CISADA, any company found to be in violation of the legislation will be subject to at least three of a menu of nine possible sanctions. Potential sanctions listed under CISADA include the freezing of property



ORIGIN OF COMPANIES ACTIVELY INVOLVED IN IRAN’S PETROLEUM SECTOR OR IN MINERAL EXTRACTION ACTIVITIES IN IRAN

SOURCE: SUSTAINALYTICS’ IRAN COMPLIANCE SERVICE

and property interests in U.S. jurisdictions, and prohibition from foreign exchange transactions in U.S. jurisdictions.

Although both amount to a de facto ban on investing in the development of Iran's energy sector, the U.S. and EU legislations differ slightly. The most significant difference is with respect to the export of refined petroleum to Iran, which is permitted under the EU regulation. Most major companies will likely choose to comply with the more stringent CISADA, which explicitly bans the export of refined petroleum to Iran, so as not to lose access to the U.S. market.

For many companies in the energy sector, these prohibitions against activity are not welcome. According to the U.S. Energy Information Administration, Iran holds the world's third-largest proven oil reserves and the second-largest natural gas reserves. Operational agility for these industries is intrinsically low. In the case of Iran, companies also face significant entry barriers. As with most emerging markets, building relationships and trust are critical to a company's success. Building relationships with stakeholders and navigating Iranian bureaucracy has been a significant investment for the majority of the companies involved in Iran. Recently leaked diplomatic cables revealed frank admissions from the chief executives of Total and ENI; they intend on returning to Iran once the political context improves.<sup>1</sup>

Likely because of this pressure, American officials are sensitive to the strategic considerations of major oil and gas companies. In October 2010, a U.S. delegation to China reportedly avoided calling for a complete halt to energy cooperation with Iran, and instead asked for "near-term pragmatic restraint." Other companies with energy interests in Iran would do well to adopt this strategy; suspending or downscaling operations is the favoured means by which to address the current risks to operating in Iran. An explicit public commitment to this end allows companies to avoid potential sanctions as per the *Special Rule* in CISADA, which allows the Secretary of State to waive investigations into sanctions violations against companies who provide assurances that they will not undertake any new investments in Iran's energy sector.

Most major oil and gas companies have taken advantage of the Special Rule. **ENI, Total, Royal Dutch Shell, Statoil**, Japanese oil company **INPEX** and American oil-services company **Schlumberger** all committed over the past year to ending their business ties with Iran. Yet they will likely retain a footprint in Iran for the foreseeable future as a matter of both strategic planning and operational realities. As the research from Sustainalytics' Iran Compliance Service demonstrates, even companies with minor operations in Iran retain legacy commitments in the country for several years after pledging to end business ties. For example, although **Xerox** terminated its distribution agreements with suppliers in Iran in 2006, it continues to have legacy obligations and in 2009 derived over USD 2.5 million in revenue from its relationships in Iran.

The oil and gas companies that have had complex and diverse operations in Iran are therefore expected to have protracted cessations of their operations. Only Statoil has been explicit regarding its remaining obligations, stating that the company has pledged to continue providing technical assistance on Iranian oil projects until 2012. ENI has stated that it will continue to receive Iranian crude for at least another three years, as a return on prior investments in Iran. As for Royal Dutch Shell and Total, they have not commented as to what extent their

### Sanctions Against Oil and Gas Activities

Violations of the CISADA provisions may result in penalties against any person who:

- Invests USD 20 million or more over the course of a 12-month period that could "contribute to Iran's ability to develop its own petroleum resources." Petroleum resources are defined as petroleum, refined petroleum products, oil or liquefied natural gas tankers, and products used to construct or maintain pipelines used to transport all petroleum products.
- Provided, sold or leased refined petroleum products to Iran valued at USD 1 million in a single transaction (or USD 5 million over the course of 12 months). Refined petroleum products include jet fuel, gasoline and aviation gasoline.
- Provided, sold or leased goods, services or other support for the maintenance or expansion of Iran's refining capabilities.

operational obligations in Iran continue, although media reports indicate that they continue to legally engage in the purchase of crude oil from Iran.

## Sanctions Against Involvement in the Financial Sector

The sanctions on Iran's financial industry have had the most extensive implications, as they have effectively cut off the country from dollar transactions and made any payments in and out of the country increasingly difficult (see text box).

Of all the restrictions, those on U-turn transactions (see text box) have proven to be the most problematic for financial institutions, particularly for banks that hold correspondent accounts with both Iranian and American institutions. In recent years, **Credit Suisse**, **Barclays** and **Lloyd's TSB** have all been fined hundreds of millions of dollars for violating U.S. financial sanctions on Iran, and reports at the end of 2010 indicated that **Commerzbank** was anticipating a similar fine in light of an ongoing investigation into transactions the company facilitated involving Iran.<sup>2</sup>

While the dollar amount of the fines has not had a material effect on any of these institutions, they should be sensitive to the reputational risk that relations with Iran can pose. The U.S. Treasury's under-secretary for terrorism and financial intelligence Stuart Levey admitted in a 2010 interview that beyond actual regulations, his department has been actively trying to build a "coalition of the private sector" against doing business in Iran. Levey insists that Iran "uses channels of legitimate commerce...to facilitate illicit conduct" and therefore leaves all entities working with Iran liable to reputational risk.

Certainly, this argument, combined with the financial sanctions on Iran, has convinced many companies whose operations are not otherwise affected by sanctions, such as **Toyota**, to halt operations in the country. In August 2010, Toyota announced a halt to exports to Iran, stating that "firms continuing to do business with Iran have come under scrutiny by the U.S. government."

### Sanctions Against the Financial Sector

- The United Nations Security Council has, over the course of four resolutions against Iran, sanctioned three of Iran's major banks: **Bank Mell**i, **Bank Saderat** and **Bank Sepah**. The U.S. and the EU have sanctioned an additional 13 banks, seeking to cut off Iranian access to the international financial system.
- U.S. legislation prohibits financial institutions from conducting *U-turn transactions* meaning that U.S. banks cannot facilitate any sort of transaction involving Iranian nationals or the government of Iran, even if the transaction is passing through a U.S. financial institution from one non-Iranian financial institution to another.
- The EU and Japan have passed legislation mandating that any Iran-related transaction involving more than EUR 40,000 has to be pre-authorized.

Others have chosen to continue conducting business in Iran. A recent Platt's report noted that petrochemical importers — whose activities are not targeted under sanctions — are subverting the financial sanctions through bank cheques, remittances, escrow accounts and *hawala*.<sup>3</sup> In some countries, such as South Korea, government-run banks are facilitating trade; in others, such as China, small private banks without western shareholders are continuing to do business with Iran.

Companies that continue to import from, or export to, Iran should disclose their recognition of sanctions and plans for mitigation, because they are exposing themselves to potential regulatory and reputational risks, particularly if they are using unofficial channels such as hawala or remittances. Transparent corporate communication regarding operations in, or business relationships with, the Islamic Republic of Iran is the best way for companies to maintain strategic interests while minimizing risk exposure.

## Sanctions on Shipping and Insurance Activities

Ties between Iran's shipping industry and the blacklisted Islamic Revolutionary Guard, as well as allegations of illicit activity, have resulted in broad sanctions that prohibit cooperating with or servicing Iran's shipping industry (see text box).

The effects of sanctions on the shipping industry are not yet tangible. Industry sources have reported that the number of product tankers calling on Iran has actually increased by about 20 per cent over the past year, and figures released recently indicate that the volume of goods passing through Iranian ports has also increased by eight per cent (although the volume of sanctioned oil products has fallen).

However, protection and indemnity insurers have actively responded by including Iran clauses, allowing them to refuse charterer orders for Iran. Despite the broad nature of the sanctions against insurance and reinsurance, industry experts have noted that the inclusion of an anti-avoidance clause in CISADA is a strict call for compliance; according to one expert, "you can be prosecuted simply for examining ways in which you can avoid the sanctions."<sup>4</sup> Almost immediately after the U.S. enacted CISADA, Lloyd's of London announced that it would no longer underwrite ships carrying petroleum to Iran.

### Sanctions Against Shipping and Insurance Activities

- United Nations Security Council has called on states to exercise vigilance over the Islamic Republic of Iran Shipping Lines (IRISL). The U.S. and the EU have outright sanctioned IRISL, and the U.S. has sanctioned dozens of other entities based in Malta, Cyprus and Germany that it claims act as front companies.
- EU sanctions prohibit the provision of insurance or reinsurance to any Iranian entity, or any entity acting on behalf of an Iranian entity, with an exemption for ships temporarily located in Iranian waters.
- Shipping companies are also liable under the provisions of CISADA, specifically the prohibition of support valued at USD 1 million or more, or USD 5 million or more over a 12-month period that could directly and significantly contribute to Iran's ability to import refined petroleum products.

## Topics for Engagement

Since 2007, divestment and engagement mandates regarding corporate involvement in Iran have been implemented in more than half of U.S. state legislatures, usually calling for divestment from companies that violate the *1996 Iran Sanctions Act* by making significant investments in Iran's energy sector. Given the expansive regulation passed in 2010, which goes beyond the 1996 legislation, Sustainalytics recommends that investors conduct an assessment of their exposure to equities involved in Iran, looking particularly at the transparency and risk management practices of their holdings.

### Improved Transparency

Companies must be transparent about their operations in Iran, publicly disclosing the extent of their operations and their compliance with applicable legislation. When a company announces a halt to their operations in Iran, investors should demand clarity as to what such a halt means. For example, a company should clearly disclose if it intends to confirm pending bids, maintain its share in existing projects in Iran, or honour existing contracts or contractual renewal rights. Otherwise, companies are inviting suspicion from both interest groups, who are an exceptionally vocal stakeholder group with regards to Iran, and regulatory agencies.

Perceived non-compliance with commitments can be damaging to a company's reputation. For example, recent news that **Royal Dutch Shell** continues to purchase crude oil from Iran garnered several headlines, despite the fact that there is no evidence of sanction violations. Similarly, a November report in the *Boston Globe* that **Schlumberger** will remain in Iran until at least 2013, with contracts valued at an estimated USD 400 million, was

met with criticism and calls for the withdrawal of the Special Rule.<sup>5</sup> By communicating the terms of remaining relationships with Iran at the outset, companies can avoid taking a defensive posture later on.

## Risk Management

For the finance, shipping, and insurance industries, the sanctions on Iran can trigger broader investment risk management in the areas of compliance systems and internal monitoring. Following **Maersk Line Ltd's** USD 3.1 million fine for violating U.S. embargoes on trade with Iran, a company official admitted that the incident had exposed inadequate cargo-management systems and insufficient training among employees regarding trade sanctions. Similarly, after the U.S. Office of Foreign Assets Control began its investigation of **Credit Suisse** (an investigation that eventually resulted in a USD 536 million penalty), the bank initiated an internal investigation that resulted in the termination of business with a number of blacklisted entities and the appointment of a global sanctions compliance officer.

Sanctions are a test of a company's ability to implement robust internal compliance systems. Experts agree that this is a complex and resource-intensive process, particularly as blacklisted Iranian entities increasingly use front companies to subvert the sanctions. The International Chamber of Commerce's Commercial Crime Services arm recently reported a spike in document fraud around shipments to and from Iran. Shipping companies are expected to strengthen monitoring systems, including cooperation with international organizations, in order to detect such fraud. CISADA includes a waiver for underwriters and insurance providers that the U.S. President deems to have exercised due diligence in establishing and enforcing official policies, procedures and controls to ensure that the entity at issue did not contravene sanctions.

In order to demonstrate due diligence, companies in sensitive industries like finance and insurance need reliable systems to ascertain and vet all parties when completing transactions. A strong sanctions compliance program must include employee training and risk assessment, and be implemented across the scope of a company's operations. After identifying their exposure to companies with transactions related to Iran, it is recommended that investors engage to ensure that companies have comprehensive management systems in place to ensure sanctions compliance.

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## Endnotes

<sup>1</sup> See, for example, Wikileaks cable, 10PARIS71, Staffdel Kessler Engages The French On Iran (<http://213.251.145.96/cable/2010/01/10PARIS71.html>).

<sup>2</sup> Lenzer, Christiane. "Commerzbank Says Cooperating with U.S. on Iran Probe." Bloomberg [New York] 25 November 2010.

<sup>3</sup> "Importers of Petrochemicals from Iran Find Ways around L/C Problem - Petrochemicals | Platts News Article & Story." Energy Products & Services, Oil, Coal Insight, Natural Gas Shipping, Electric Power Methodology Analysis, Metals, Petrochemical, Reference - Platts. 18 October 2010.

Hawala refers to an informal money transfer system where money is not physically wired but transferred through a network of global hawala dealers.

<sup>4</sup> Guy, Jon. "IUMI 2010: Underwriters Facing Chaos over Iran Sanctions." Lloyd's List [London] 15 September 2010.

<sup>5</sup> Stockman, Farah. "Oil Firm Says It Will Withdraw from Iran." Boston Globe, 12 November 2010. Print.

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