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Global Compliance Risks Increase with Expanded International Sanctions Against Iran

Recent sanctions against Iran have garnered international attention and raised compliance concerns. The Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 signed into U.S. law by President Obama on July 1, 2010, the European Union's commitment to expanded sanctions on June 17, 2010, and the UN Security Council's Resolution 1929 adopted on June 9, 2010 are the most recent developments in a long history of sanctions directed at Iran. These measures are directed at specific aspects of Iran's economy, in particular Iran's nuclear program, its production and importation of refined petroleum products, and Iran's Revolutionary Guard Corps. In light of these developments, there are increased risks for any business engaging in transactions in Iran or with Iranians.

The new unilateral U.S. sanctions go beyond those imposed by the United Nations or contemplated by the European Union. The U.S. legislation broadens the restrictions on business related to Iran's petroleum products sector, imposes new prohibitions on financial institutions and new requirements for U.S. government contractors, strengthens the requirement that potential violations be investigated, and narrows the President's discretion to waive enforcement. However, the new U.S. sanctions do not change the so-called "U.S.-EU Understanding" on extraterritorial sanctions.

The U.S., EU, and UN actions all present compliance concerns. This client publication provides an overview of key developments and implications.

Background

U.S. economic sanctions against Iran already prohibit almost all imports and exports between the United States and Iran. Additionally, "U.S. persons," including U.S. companies, citizens, permanent residents, and anyone physically located in the United States, may not trade in Iranian oil or petroleum products refined in Iran, nor may they perform services, provide financing, or supply goods or technology that would benefit the Iranian oil industry. U.S. persons are also prohibited from facilitating any prohibited business with Iran.

The Iran Sanctions Act (enacted in 1996 as the Iran and Libya Sanctions Act and renewed in 2006) prohibits persons anywhere in the world from (i) making investments of more than \$20 million in a 12 month period that significantly

contribute to Iran's ability to develop its petroleum resources, and (ii) exporting goods, services, or technology to Iran knowing that it would contribute to Iran's ability to develop or acquire certain weapons.

Following the passage of the Iran Sanctions Act, the European Union brought a challenge in the WTO to the extraterritorial aspects of U.S. economic sanctions. The U.S.-EU Understanding came about in 1997 when the European Union agreed to withdraw its WTO challenge and the United States agreed to waive enforcement against EU companies of provisions of the Iran Sanctions Act and the Helms-Burton Act targeting Cuba.

Since the enactment of the Iran Sanctions Act, there have been more than 20 major investments or agreements to invest in Iran's petroleum resources. These investments are valued at more than \$40 billion. However, reflecting the U.S.-EU Understanding, no sanctions have ever been imposed under the Iran Sanctions Act against EU or any other non-U.S. company. In 1998, President Clinton waived sanctions against Gazprom, Petronas, and Total for investments in Iran's petroleum sector. Non-U.S. companies, however, have been penalized (in so-called "stripping cases") for causing U.S. persons to violate the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC") sanctions against Iran, such as the regulations regarding financial transactions with Iranian entities. In addition, investments by U.S. persons in non-U.S. companies that engage in business with Iran have come under increased scrutiny under state and local divestment laws.

Congressional frustration with the lack of penalties under the Iran Sanctions Act, concern about Iran's nuclear program, and media reports about foreign companies that do substantial business in Iran's petroleum sector while also doing business with the U.S. government all contributed to efforts by Congress to tighten the existing sanctions regime and to increase the likelihood of enforcement.

U.S. Legislation

The Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (the "Act") passed Congress by an overwhelming margin. The Act extends the Iran Sanctions Act until December 31, 2016 and adds new sanctions and enhances existing ones. Many of the Act's new provisions are effective immediately. Noteworthy aspects are discussed below.

Expanded Petroleum Sector Sanctions

The Act maintains the sanctions for knowingly investing \$20 million or more in a 12 month period that significantly contributes to Iran's ability to develop its petroleum resources. The Act expands petroleum sector sanctions to include knowingly (i) selling refined petroleum products to Iran,¹ and (ii) providing Iran with goods, services, technology, or support that directly and significantly (a) facilitates Iran's ability to refine petroleum products domestically or (b) contributes to Iran's ability to import refined petroleum products. The threshold value for these new violations is \$1 million per transaction, or \$5 million during a 12 month period.

¹ Refined petroleum products are defined to include diesel, gasoline, jet fuel (including naphtha-type and kerosene-type jet fuel), and aviation gasoline.

These new sanctions apply to activities engaged in on or after July 1, 2010. Investments made prior to July 1, 2010 are “grandfathered” such that they are not sanctionable to the extent that they were permissible under the terms of the Iran Sanctions Act at the time of the investment.

The Act adds three new sanctions to the previously available six and requires the President to impose at least three from this new list of nine sanctions. The three new sanctions prohibit:

- access to foreign exchange in the United States;
- access to the U.S. banking system; and
- transactions in U.S. property.

They are in addition to the six sanctions providing:

- a ban from U.S. government procurement;
- a prohibition on transactions with the U.S. Export Import Bank;
- denial of certain U.S. export licenses;
- denial of U.S. bank loans over \$10 million in one year;
- restrictions on financial institutions’ dealings in U.S. government bonds; and
- restrictions on imports to the United States.

Thus, the new sanctions could have a significant impact on the ability of any company found to be in violation of the Act to do business in the United States or with U.S. persons.

Prohibited investments and activities are greatly expanded. Although it is clear that companies that supply Iran with refined petroleum products are targeted by the Act, the goods, services, technology, and support that directly and significantly assist Iran’s importation and domestic refining of refined petroleum products are not defined. Accordingly, it is important to re-evaluate all possible connections to Iran’s petroleum sector.

Knowledge Requirement

The Act’s definition of “knowingly” engaging in a prohibited transaction makes it clear that the government may satisfy its burden either through proof of actual knowledge or that an entity was aware of sufficient facts that it should have known.

OFAC has previously indicated that “reason to know” that a transaction involves prohibited activities can be established through a variety of circumstantial evidence, including, “course of dealing, general knowledge of the industry or customer preferences, working relationships between the parties, or other criteria far too numerous to enumerate.”

As a result, sufficient due diligence should be conducted to know the end-users of products and determine if they are likely to divert the product to prohibited activities in Iran. When products could have multiple uses, companies should consider whether they could be used in the petroleum or nuclear sectors. This analysis and careful investigation of any red flags should be conducted prior to the completion of transactions that there is any reason to know involve prohibited activities.

Shipping, Insuring, and Financing

Providing ships or shipping services, underwriting or entering into a contract to provide insurance or reinsurance, and providing financing or brokering services are all specifically identified as actions that could directly and significantly contribute to the enhancement of Iran’s ability to import refined petroleum products.

The focus on these industries suggests a high degree of vigilance in compliance is required. Exercising due diligence in establishing and enforcing official policies, procedures, and controls to ensure that insurance is not provided in connection with Iran's acquisition of refined petroleum products is explicitly identified as a reason for the President not to impose sanctions. Although this exception applies to the insurance industry, companies with any potential connection to Iran's acquisition of refined petroleum products should conduct such due diligence.

Increased Scope of Liability

The Act makes a wider range of parties subject to sanctions based on their relationship with the party engaging in prohibited activities. Sanctions can be imposed on (i) successors in interest, (ii) persons who have ownership or control and knew or should have known about sanctioned activity, and (iii) subsidiaries and affiliates under common ownership or control if the subsidiary or affiliate knowingly engaged in sanctioned activity. U.S. companies can be liable for the acts of their foreign subsidiaries.

Companies should consider not only their own activities, but those of parties with whom they have close relationships. Further, exposure to sanctions risk should be incorporated into due diligence in mergers or acquisition transactions. Similarly, lenders and underwriters should consider this increased scope in evaluating transactions.

Requirements for Financial Institutions

Within 90 days of July 1, 2010, the Secretary of the Treasury will issue regulations implementing new requirements for foreign and U.S. financial institutions.

Foreign Financial Institutions

The regulations will prohibit or impose strict conditions on a foreign financial institution's ability to open or maintain correspondent or payable-through accounts in the United States if the foreign financial institution:

- facilitates the efforts of the Government of Iran, including Iran's Revolutionary Guard Corps or its agents or affiliates, to acquire weapons of mass destruction or provide support for terrorist organizations;
- facilitates the activities of a person subject to UN Security Council resolutions on Iran;
- engages in money laundering to do so;
- facilitates efforts by the Central Bank of Iran or other Iranian financial institutions to do so; or
- facilitates a significant transaction or provides significant financial services for Iran's Revolutionary Guard Corps or its blocked agents and affiliates or a financial institution blocked in connection with Iran's weapons of mass destruction program or Iran's support for international terrorism.

If a foreign financial institution is prohibited from maintaining U.S. accounts, it and its customers will have difficulty conducting transactions in the United States or in U.S. dollars.

U.S. Financial Institutions

Subsidiaries of U.S. financial institutions will also be prohibited from engaging in transactions with or benefiting Iran's Revolutionary Guard Corps or any of its blocked agents or affiliates.

U.S. financial institutions will be responsible if they knew or should have known that a subsidiary violated or attempted to violate the Act.

In addition, U.S. financial institutions that maintain correspondent or payable-through accounts for foreign financial institutions will be required to do one or more of the following:

- audit the relevant activities of the foreign financial institution;
- make reports to the Treasury Department of prohibited activities;
- certify to the best of its knowledge that the foreign financial institution is not engaged in prohibited activity; and
- establish due diligence policies, procedures, and controls reasonably designed to detect whether the foreign financial institution is engaged in prohibited activity.

Financial institutions engaging in transactions in Iran or with other financial institutions doing business in Iran will have new responsibilities to monitor these interactions. Although the final form of the Treasury regulations is not set, financial institutions should begin reviewing their controls and determining whether new or enhanced controls will be necessary to comply with the expected terms of the new regulations.

Government Procurement

The Act requires companies that receive U.S. government contracts to cease sanctionable conduct. Companies bidding on new U.S. government procurement contracts will be required to provide a certification that they are not engaged in sanctionable conduct. The requirements for the certificate will be set out in the Federal Acquisition Regulations within 90 days of July 1, 2010. The consequences of submitting a false certification include debarment for three years. The President can waive the certification requirement if it is in the national interest of the United States to do so.

Companies that export technology to Iran that is used to restrict the flow of information and freedom of speech will also be banned from U.S. government procurement.

Although the exact requirements of the certification will not be known until the new regulations are issued, companies wishing to do business with the U.S. government should consider how to verify across all entities under their ownership or control that they are not engaged in sanctionable conduct. Companies should expect that senior officials with sufficient authority to ensure the information is accurate will be responsible for the certification.

Diversion

The Act reflects considerable concern about diversion of sanctioned products from non-sanctioned countries to Iran. It provides for procedures to designate countries as destinations of diversion concern and then impose restrictions on exports to countries so designated.

Companies should carefully monitor sales to locations considered possible points of diversion to ensure products are not diverted to Iran. A March 2010 U.S. Government Accountability Office report to Congress identified the U.A.E., Malaysia, and Singapore as possible points of diversion.

Decreased Presidential Discretion

The Act seeks to limit Presidential discretion and increase the likelihood that the executive branch will bring enforcement actions under the Iran Sanctions Act. The Act requires the President to investigate credible reports of sanctionable activity and make public reports to Congress. The President can waive the imposition of sanctions after a violation is found, but the bar for waiver is raised from “important” to U.S. national security interests to “necessary” to U.S. national security interests.

Acknowledging the U.S.-EU Understanding, the President can waive the imposition of sanctions if the government of the person subject to sanctions is closely cooperating with the United States in multilateral efforts to combat Iran's weapons programs and it is "vital" to U.S. national security interests to do so. This is not a blanket exemption for cooperating countries and a finding of violation by the President is part of any waiver process. Waivers remain a complex political matter.

Divestment

State and local governments will be permitted to divest their assets from, and to prohibit investments in, companies and financial institutions doing certain types of business in Iran's energy sector. Numerous divestment initiatives already exist, and the Act helps further enable these efforts.

The combination of a strengthened legal framework for divestment and a number of public reporting requirements imposed by the Act is likely to increase Congressional and public pressure on companies doing business in Iran.

UN and EU Sanctions

UN Security Council resolution 1929 is the fourth round of UN sanctions imposed on Iran. Expressing concern about Iran's failure to comply with previous UN resolutions regarding its nuclear program, the United Nations expanded the arms embargo and tightened restrictions on certain financial and shipping activities. Like the U.S. sanctions, the UN sanctions target Iran's Revolutionary Guard Corps and specific individuals.

The European Union expressed its commitment to a new set of sanctions that both implement and go beyond the UN measures. The focus will be on (i) restricting trade in sensitive goods, (ii) a prohibition on new investment and assistance in key sectors of the oil and gas industry, (iii) the financial sector, (iv) shipping, and (v) a travel ban and asset freeze directed at Iran's Revolutionary Guard Corps.

The European Council, in its "Declaration on Iran," directed the Foreign Affairs Council to adopt new sanctions at its next session, scheduled for mid-July. It is unclear the extent to which the EU sanctions will align with the U.S. sanctions.

Blocking Statutes

Some countries have adopted countermeasures, known as blocking statutes, to limit the effectiveness of extraterritorial U.S. sanctions. These countermeasures can prohibit compliance with certain U.S. economic sanctions, whether through acts or deliberate omissions, prohibit the enforcement of certain judgments that would give effect to extraterritorial sanctions, and require reporting of the application of sanctions.

Non-U.S. persons should consider whether a blocking statute, such as EU Regulation No. 2271/96 applies and restricts their involvement in compliance with the Iran Sanctions Act.

Conclusions

Recent developments in U.S., UN, and EU sanctions have increased the risks of doing business related to Iran, and the risks are likely to increase in the future. A fuller understanding of the implications of the new U.S. sanctions will be provided by the regulations issued in the coming months, but companies should evaluate their interactions with Iran and compliance efforts given the increased scope of prohibited activity, the severity of sanctions, and new affirmative requirements, especially if they wish to maintain access to U.S. government contracts and the U.S. financial markets.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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