The Falcon’s View: What the European Union’s SPV for Trade with Iran Means for Businesses in the Middle East

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When the United States (‘**US**’) announced its withdrawal from the Joint Comprehensive Plan of Action (‘**JCPOA**’) in May 2017, the international sanctions framework was plunged into a state of chaos, as the fragile consensus concerning trade with Iran was rent apart. With the reintroduction of secondary sanctions by the US Office of Foreign Assets Control (‘**OFAC**’), an unprecedented divergence between US and EU foreign policy positions created a divide in the international sanctions framework and darkened the cloud of confusion surrounding all dealings with Iran. The latest step taken by the E3 countries to establish a Special Purpose Vehicle (‘**SPV**’) to facilitate continued trade with Iran has the potential to push the system into murkier waters still. Middle Eastern businesses that have long been caught in the fluctuating application of Iran sanctions may view the new vehicle with hope that it will bring much needed clarity to trade permissibility, but it will be some time before the SPV offers any clear direction or plausible route for trade.

The Ins and Outs of INSTEX

Backed by the E3 countries, namely France, Germany and United Kingdom ('**UK**'), though with the full support of the entire EU, it was announced on 31st January 2019 that the new SPV known as INSTEX (short for Instrument in Support of Trade Exchanges) will be based in Paris and will form the lynchpin of the EU's efforts to wedge an open channel of trade with Iran, even as the US pushes its campaign of maximum economic pressure.

Under its existing structure, the SPV will allow European businesses to trade in limited specific goods with Iranian entities by providing an alternative payment structure that does not involve cross-border payments with Iranian financial institutions. It will further avoid the extensive reach of US sanctions at this stage by dealing only in goods that are currently exempt from US sanctions under the Countering America's Adversaries Through Sanctions Act of 2017 ('**CAATSA**'). Exempted goods are so classified based on their link to humanitarian requirements, and specifically include agricultural produce, medicine and medical equipment. In practice, INSTEX will match trade partnerships between EU and Iranian companies in a mirror-transaction system, so that EU businesses receiving goods from Iran can effect payment to European businesses due to receive funds for goods provided to Iranian entities, thereby eliminating the need for cross-border transactions.

In Between INSTEX and Operations

A number of obstacles still lie between INSTEX and full functionality. Its establishment in Paris, though no small feat (considering the reluctance of many countries to openly act in contravention of US foreign policy and risk losing access to the US financial system), is only the first hurdle, and it will be several months before the E3 powers have finalised the necessary technical legal and operational mechanisms for the SPV to grind into action. Additionally, for this system to work, an INSTEX equivalent will need to be established in Iran, so that payments due to Iranian entities can be coordinated simultaneously in the same way. This should not be taken for granted, as Iran's mirror company will likely face pressure from both EU countries and the US to maintain a high degree of transparency, as well as robust anti-money laundering and counter terror financing standards – areas where Iran has historically struggled to satisfy international requirements despite enduring efforts by the Financial Action Task Force ('**FATF**'). In addition, the efforts of the Iranian Government will likely face staunch domestic opposition to continued co-operation with the remaining JCPOA signatories, which may hinder its progress.

Outside the INSTEX Mandate

In its current form, INSTEX is not quite the open declaration of defiance by the E3 powers that was reported when the prospect of an SPV was first announced in the aftermath of the US withdrawal. Early statements made by Federica Mogherini, the EU Chief Diplomat, and E3 Finance and Foreign Affairs Ministers, hinted at more grandiose plans for access to Iran's market, primarily aiming to continue the spirit of the JCPOA and allow legitimate trade shielded from US sanctions. In practice, however, under its current proposed structure the SPV will be neither as extensive nor as mobile as hoped by the E3 countries.

Early sceptics who doubted the SPV would ever be robust enough to protect risk-resilient oil traders from the full weight of US secondary sanctions have been proven mostly right. Despite its sovereign backing by three of Europe's largest economies to mitigate against the strength of Washington, the diplomatic shield around INSTEX will not completely remove the risk of punitive sanction that has afflicted and restricted the private sector even during the brief sanctions relief effected under the JCPOA. INSTEX will not facilitate trade in oil or other goods beyond those that are the bare minimum for Iran's population, and it is unlikely to provide enough assurance to tempt large corporations that face higher exposure to the US financial

system and fear punitive actions by US authorities. Due to the dominance of the US dollar in the international trade system, and its almost exclusive primacy as the denomination of global oil contracts, any measure that could release oil exports from the vice of OFAC sanctions is a distant concept at best. Rather, INSTEX's limited initial mandate is a modest application of the E3 intentions to preserve Iran's sanctions relief and in its nascent stages will mostly target small businesses with limited ties to the US' sweeping jurisdiction.

Transatlantic Drift

In establishing the SPV, the EU is effectively signalling its intent to continue to pursue the merits of the JCPOA and protect the interests of its member states where they are not aligned to US foreign policy.

This resounding sentiment has been echoed across other EU statements and actions. In December 2018, the EU published a report entitled 'Towards a Strong International Role of the Euro', advocating the need to strengthen the relative clout of the Euro against the US Dollar. One of the prominent motivations given for doing so was the creation of sufficient leverage that EU States could wield economic sovereignty, and reduce their exposure to unilateral actions taken by third party countries, such as economic sanctions.

The International Response

US responses to the SPV have been muted to date, due to the SPV's narrow scope of application to compliance trade. US authorities will, however, likely watch the impending process of bringing the SPV into operation with a wary eye, watching for any attempts by EU powers to move into a position of outright circumvention. Future measures taken to expand the INSTEX mandate have the potential to bring it into more direct conflict with US sanctions, and E3 countries have already confirmed aspirations that the vehicle will be opened to third party countries once operations have been established. From a US perspective, there will be acute concerns that an expanded EU SPV may provide both means and direction to other countries seeking ways to limit their own exposure to the punitive reach of OFAC sanctions.

Responses from Iranian authorities meanwhile have been similarly restrained. Whilst the initial announcement was greeted by relative optimism, an undercurrent of dissatisfaction with the delay and inadequacy of the E3's efforts with INSTEX has become apparent in subsequent statements. Growing domestic pressure in Iran will mandate that it demand more tangible progress from EU countries on this front sooner rather than later.

A Falcon's Eye View: The Middle East Perspective

The establishment of INSTEX should not be interpreted as a sign that trade with Iran is broadly more acceptable, or has finally cleared the period of flux that has dominated trade restrictions. For now, the vast majority of trade with Iranian entities remains prohibited under the full extent of US economic sanctions as of 4 November 2018, and even non-US persons will need to be careful to trace their connections to US jurisdiction before taking any action contrary to US foreign policy. Middle Eastern businesses, for example, in addition to their obligations under applicable United Nations Security Council Resolutions, will need to evaluate key issues such as whether any US dual-nationality employees, trade in US-origin goods, ties to the US banking system or US-based resources are sufficient to bring their activity under the remit of OFAC restrictions.

Aside from goods exempted under CAATSA, the only trade permissible under the current sanctions framework is the reduced oil trade by Iran's biggest oil exporters under temporary waivers granted by the

US, namely China, India, South Korea, Japan, Italy, Greece, Taiwan and Turkey. These are not permanent exclusions, however, and have been granted only to alleviate the shock of US snapback sanctions on the oil market. The waivers have a fixed duration of 180 days, after which the US will resume its efforts to reduce Iran's oil exports to zero and may refuse to grant any extensions after they expire in early May 2019.

Caught in the Middle, or choosing a side?

Initially, INSTEX will only be available to EU countries, though it is possible that third party countries will be invited to join the initiative once its operations are established, subject to its efficacy. Middle Eastern businesses that are resolved to trading with Iran, meanwhile, will still have to face the seemingly insurmountable challenges that currently restrict trade flows. Notwithstanding the intricacies of identifying US jurisdiction, even compliance trade with parties not subject to OFAC sanctions is effectively blocked by the unwillingness of international banks to act as conduits for Iranian trade.

Middle Eastern banks and businesses have not been immune to the impacts of the US' 'maximum pressure campaign', as de-risking, involving the severance of ties by most Financial Institutions to their Iranian counterparts, has effectively prevented all trade with Iranian entities. The absence of viable legitimate routes to trade has driven frustration for businesses looking to trade permitted goods with Iran. Due to the closer proximity with Iran, Middle East-based businesses face an increased risk of abuse by criminal actors attempting to circumvent sanctions by means of disguising or smuggling prohibited goods intended for or originating from Iran, or carrying out restricted business under the anonymous cover of a steady stream of cross-border cash payments. Cryptocurrencies are also emerging as a potential means to disguise flows of funds, with the appeal of anonymity bolstered by the absence of the heavy regulation, monitoring and compliance requirements that dominate the global financial system. Many financial regulators worldwide are already attempting to bring this flow of funds under supervision, with some Middle Eastern jurisdictions consciously trying to balance the potential of emerging technologies with defending against potential risks.

For Middle East businesses with EU registered affiliates, the SPV may provide an option for legitimate trade, but the true extent of INSTEX's accessibility will remain a nebulous concept until the E3 powers have made significant headway in establishing its underlying legal mechanisms.

A State of Disarray?

The global sanctions framework remains in a state of disarray, with the unprecedented divergence between EU and US positions casting confusion over compliance trade with Iranian entities. Ripples of this uncertainty have spread to every part of the international system, and Middle Eastern companies have found themselves trapped between the regulatory environment and threats posed by geographical proximity to Iran.

Crucially, INSTEX is not a mechanism to circumvent the US' extensive economic sanctions regime on Iran, and its sovereign backing will not offer European businesses carte blanche to trade with Iran without fear of US punitive action any time soon. Future steps to widen the channel of trade through the SPV will be contingent on a number of factors, including proof of its effectiveness in its early stages, support for increased trade from third party countries outside of the EU, and any retaliatory blocking actions taken by the US authorities to prevent efforts to undermine its sanctions regime. This will be an interesting development to monitor over the coming months as further details of INSTEX's reach and operations are released.

Perhaps the greatest factor that will determine the future of the SPV is the continued divergence between EU and US policy positions, and the ensuing discord within their respective sanctions regimes. As an added complication, the ensuing departure of the UK from the EU has the potential to again create a further

divide in sanctions practices where previously there has been reliable unanimity. The recently released UK post-Brexit Sanctions Guidance, for example, highlights the areas in which the UK will have renewed freedom to apply its sanctions with impunity, and may spark further dissonance within the sanctions ambit of the Western hemisphere. Though these developments may appear as distant concerns to Middle East businesses, the global span of US and EU extraterritorial jurisdiction, not to mention the political flexing that often accompanies policy changes, brings sanctions issues into immediate importance on a universal scale. All businesses, and particularly those that are based in the Middle East, should anticipate further uncertainty and should continue to stay abreast of changes in the international sanctions climate that threaten to trap legitimate vendors in a paralysing state of uncertainty.