FRIENDS OF ISRAEL INITIATIVE

Risky Business: perils and pitfalls of entering the Iranian markets

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Introduction

In July 2015, Iran and six world powers agreed to implement a Joint Comprehensive Plan of Action, or JCPOA, to address Iran's nuclear program and the international challenges it gave rise. The JCPOA thus brought a decade of sanctions and international negotiations to a close.

In exchange for limitations over Iran's nuclear activities over the next fifteen years, Tehran obtained a commitment to see international sanctions suspended and eventually lifted. The agreement was quickly enshrined in a United Nations Security Council resolution (UNSCR 2231) and implemented on January 16, 2016. Some restrictions remain on the sale and export of dual-use technology to Iran; and the nuclear agreement does not apply to U.S. and European Union sanctions targeting Iran's Revolutionary Guards or IRGC, and Iranian individuals and corporate entities sanctioned for human rights' violations, terrorism, or ballistic missile proliferation. These restrictions notwithstanding, as of Implementation Day, Tehran is officially open for business.

The nuclear deal has made investment in and trade with Iran once again legal, but it did not rehabilitate Iran's business environment or remove some of the factors that justified the introduction of international sanctions against Iran's economy. As global business naturally looks to Iran as a renewed opportunity, it is imperative that it also understands the perils and pitfalls of entering the Iranian market. Mainly, there are two risks.

First, Iran's banking system remains tainted by its key role as a conduit for terror finance; and second, the IRGC and other powerful state actors such as the Supreme Leaders' business conglomerate control the most important sectors of Iran's economy and are likely to monopolize public sector contracts. Doing business in Iran is virtually impossible, unless one is prepared to rely on a still essentially tainted financial system and risk partnerships and transactions with the IRGC.

This is why entering Iran's market remains a risky business.

Lifting sanctions under the JCPOA

According to the JCPOA, initial sanctions relief occurred immediately after Iran met some preliminary nuclear benchmarks; after periods of time ranging from five to fifteen years, additional sanctions will be lifted and restrictions on Iran's nuclear activities will lapse. In exchange for compliance, Iran will emerge in fifteen years as a threshold nuclear power with an industrial-size enrichment program, an advanced, long-range ballistic missile program, access to advanced, conventional heavy weaponry, and a more powerful economy.

The key benchmarks of the deal, for the purposes of understanding how sanctions are gradually phased out, are Adoption Day, Implementation Day, and Transition Day. Adoption Day refers to the date on which Iran began implementing its nuclear obligations and the P5+1 issued the necessary regulations to lift or suspend sanctions upon Implementation Day (October 18, 2015)[1]. Implementation Day refers to the day when, simultaneous with the verification by the International Atomic Energy Agency (IAEA) that Iran completed certain nuclear commitments, the U.S., EU, and UN suspended certain sanctions (January 16, 2016)[2]. And Transition Day refers to the day, when the IAEA reaches a so-called broader conclusion that there is no undeclared nuclear activity in Iran and that all nuclear activities are peaceful in nature. At that point, additional U.S., EU, and UN sanctions are terminated (18 October 2023).[3]

Iran could meet all benchmarks to remove all sanctions and restrictions on its nuclear activities without taking any step needed to rehabilitate its economy, first and foremost its financial sector.

Banking and finance

Over the past decade, international sanctions sought to target the full range of Iran's illicit activities, not only Iran's clandestine nuclear procurement. A primary goal of sanctions on Iran, as explained by senior U.S. Treasury officials, was to "protect the integrity of the U.S. and international financial systems" from Iran's illicit financial activities.[4] As part of this strategy, the United States escalated sanctions and designated numerous Iranian banks, inflicting heavy fines against financial institutions that violated them. Iranian banks, for their part, cooperated with their regime in facilitating its illicit procurement and money laundering activities.

The Iranian banking sector was targeted under multiple U.S. and international authorities for lax money laundering and terror finance standards. In November 2011, Treasury issued a finding under Section 311 of the USA PATRIOT Act that Iran and its entire financial sector was a "jurisdiction of primary money laundering concern."[5] Treasury highlighted Tehran's support for terrorism, pursuit of conventional and nonconventional weapons, and use of "deceptive financial practices to facilitate illicit conduct and evade sanctions."[6]

Internationally, the Financial Action Task Force (FATF), a global anti-money laundering and anti-terror finance standards body, has repeatedly warned its members that they should "apply effective counter-measures to protect their financial sectors from money laundering and financing of terrorism (ML/FT) risks emanating from Iran."[7] As recently as February 2016, FATF warned that the Iranian "failure to address the risk of terrorist financing" poses a "serious threat…to the integrity of the international financial system."[8]

On Implementation Day, however, Washington terminated financial sanctions against most Iranian banks. The European Union also lifted restrictions on banking transactions (including fund transfer) to and from Iran, financial support for trade with the country, and Iranian public-guaranteed bonds.[9] The EU also de-listed most Iranian banks that it had sanctioned over the past decade and removed restrictions on financial messaging services, allowing these de-listed Iranian banks back onto the SWIFT financial messaging system.[10]

While banking is now both legal and, thanks to the removal of sanctions, easier, this is not because of a change of banking practices or structural reforms within Iran's financial system designed to increase transparency and eradicate illicit finance. Additionally, part of the banking system remains controlled by the IRGC or continues to provide banking services to the Guards. Engaging in business and financial transactions with them could expose international banks to serious consequences.

Washington specifically mentioned the IRGC connections of six banks: Ansar, Mehr, Melli, Arian, Kargoshaee, and Future Bank.[11] The first two were created by the IRGC to provide services to its personnel and its paramilitary

Basij force, according to the U.S. Treasury and the EU.[12] Bank Ansar and Mehr are owned by the Guards, while the other four banks are not IRGC banks but rather have conducted transactions on its behalf.[13]

On Implementation Day, the U.S. and EU de-listed Bank Melli and its subsidiaries, including the aforementioned Arian Bank, Bank Kargoshaee, and Future Bank.[14] Brussels will also lift nuclear and ballistic missile sanctions on Ansar Bank and Mehr Bank in eight years.[15] The U.S. sanctions on the two IRGC-owned banks will remain in place.

The IRGC ownership appears to explain the distinction in the lifting of sanctions, but the distinction between IRGC-owned, IRGC-linked, and non-IRGC banks is immaterial because what taints a financial institution is not only its ownership but also how sanctioned entities like the IRGC rely on its services. The IRGC's financial activities are not limited only to those banks owned by the Guards or that have previously managed IRGC transactions. For example, when Treasury sanctioned Bank Melli, it noted that the institution facilitates transactions for the IRGC and engages in deceptive financial practices to hide the IRGC's involvement.[16] Other Iranian state banks have also been used as conduits for ballistic missile and nuclear proliferation financing – activities run by the IRCG. Because UN, U.S. and EU sanctions never identified more than a handful of IRGC businesses, the risk remains that Iranian banks will continue to handle transactions on behalf of the Guards. That's because by restoring Iran's financial institutions' access to the SWIFT financial messaging system and lifting restrictions on their operations, the JCPOA effectively allows all unsanctioned IRGC companies using unsanctioned and de-sanctioned Iranian banks to regain access to the global financial system. That is sufficient to enable the Guards to resume banking operations in Europe and Asia.

Additionally, as Iran's economy improves, IRGC investment firms' portfolios will grow. One of the ways the Guards invest in Iranian financial markets is through its banks and investment firms, which are directly or indirectly controlled by the IRGC Cooperative Foundation. Treasury has noted that eight of the nine members of the foundation's Board of Trustees are IRGC officials, including its commander Ali Ja'afari.[17] In addition to the IRGC-owned banks, Ansar Bank and Mehr Bank, the Guards also control investment firms such as Mehr Eghtesad Iranian Investment Company, Andishe Mehvaran Investment Company,[18] and Tadbirgaran Atieh Iranian Investment Company.[19] Tabdirgaran Atieh, for example, owns shares in Zinc Mines Development Company, Exir Pharmaceutical, Behbahan Cement, Sina Kashi and Ceramic, Rayan Saipa Leasing, Isfahan Oil Refinery and Kaveh Paper Industries.[20] As Iran's economy grows, these companies are likely to experience new business opportunities and generate profits for their investors and owners: the IRGC.

While some IRGC investment firms have been designated, others have escaped sanctions. Not only will these companies now increase their income from investments, but they will also be able to invest their assets abroad. The high number of IRGC-owned investment firms makes it difficult to identify and track entities under control of the Guards. It also provides the IRGC a complex network of financial entities that can be used in the IRGC's illicit activities such as money laundering.

Finally, as financial restrictions are lifted, Iranian banks will be able to raise capital through Iranian government public-guaranteed bonds. In turn, these bonds finance public projects contracted to IRGC companies.[21] In short, the possibility of financial transactions and investments through Iran's financial system becoming tainted by a connection with the IRGC is very high. So is the attendant risk of some future penalty.

IRGC involvement in Iran's economy

The biggest risk of doing business in Iran is that it will be nearly impossible for foreign investors and contractors to avoid engaging in transactions with IRGC-owned companies. That's because every sector of the Iranian economy that is worth considering for investment and trade has a significant IRGC presence.

The IRGC began its prominent involvement in Iran's economy soon after the end of the Iran-Iraq war, in 1988. At the time, the IRGC's presence in Iran's economy was still fairly limited, but by 1997, when Iran's reformists came to power with the election of Mohammad Khatami to the presidency, the IRGC had become one of its main players. Over the next decade, the IRGC expanded its role further, becoming a dominant actor in the food industry, manufacturing companies, telecommunications, and, more recently, the energy sector where beyond the initial involvement in the construction of infrastructure projects IRGC subsidiaries are now directly involved in all phases of the oil supply chain.[22] IRGC companies are also prominent in the services and logistics sectors, where energy consulting companies, shipping, and port services have also fallen under the IRGC's purview.

In May 2005, Supreme Leader Khamenei issued a decree permitting the government to privatize most publicly-owned industries and requiring ownership of at least 25 percent of the Iranian economy to be transferred to the private sector over a five-year period.[23] The industries involved included "large-scale oil and low-end gas industries, mines, foreign trade, many banks, shareholder-owned cooperatives, power generation, many postal services, roads, railroads, aviation, and shipping."[24] Rather than benefiting the private sector, however, a significant portion of privatization transfers went to the IRGC.[25] The gradual takeover of Iran's economy over the past three decades means that presently the IRGC holds a right of first refusal for any big public project in the country.

Today, the IRGC is Iran's "most powerful economic actor," according to the U.S. Treasury.[26] Experts calculate that the IRGC controls around 20-30 percent of the Iranian economy.[27] Its annual income may be as high as one-sixth of Iran's GDP.[28] The IRGC has "displace[d]…the legitimate Iranian private sector," created a preferential system "in favor of a select group of insiders" and "expanded its reach into critical sectors of Iran's economic infrastructure," according to the U.S. government.[29] These include a significant presence in the automotive sector through control of the third largest car manufacturer in Iran; in the telecom sector, through a virtual monopoly over mobile telephony and a majority stake in Iran's largest telecom company; in the petrochemical sector through control of minority stakes in publicly traded companies; in metals and mining; in the transportation sector and aviation industry; and in construction – the IRGC core business since the establishment, in 1989, of Khatam al-Anbia and its hundreds of subsidiaries.

Although the IRGC remains under U.S. sanctions indefinitely and under EU sanctions until Transition Day in 2024, it will be almost impossible for foreign businesses seeking trade and investment in Iran to avoid partnering with IRGC companies. U.S. Treasury designations identify 25 individuals, 25 companies, two academic institutions (Baqiyatullah University of Medical Sciences and Imam Hossein University), and four military/paramilitary entities (the IRGC air force, missile command, Quds Force, and Basij) in addition to sanctioning the IRGC itself.[30] State and Treasury have also sanctioned IRGC companies under different authorities rather than explicitly for their links to the IRGC. For example, the State Department designated Ofogh Saberin Engineering Development Company under Executive Order 13628 as an "electronic warfare entity" because it facilitates the Iranian government's efforts to "limit access to print or broadcast media" by jamming satellite signals.[31] The IRGC Cooperative Foundation sits on the board of Ofogh Saberin and as a result has direct control over the business.[32] The EU, for its part, has listed only 26 entities as IRGC-owned or controlled.[33]

Most IRGC-linked companies have not been designated by EU or U.S. authorities. These companies are now likely to benefit from the economic windfall because the international business community will presume that any Iranian company not sanctioned is a legitimate business partner. That poses a significant risk to business since these companies are theoretically under U.S. sanctions and could be designated at a later date. Nevertheless, because the gap between designated IRGC companies and those that have eluded U.S. or EU sanctions is wide, these companies will likely benefit from the JCPOA sanctions relief. In the course of our research, we have identified at least 229 companies with significant IRGC influence either through equity shares or positions on the board of directors.[34] Many more remain unidentified.

The risk that foreign companies entering the Iran market may establish business ties with these and other IRGC companies is real. The lack of additional designations by U.S. or EU authorities means that companies lack guidance for the purposes of identification of IRGC entities and may find themselves later sanctioned for failing to conduct sufficient due diligence on their own.

The Supreme Leader's Network of Corruption

Iran's supreme leader also controls significant portions of the Iranian economy. His business conglomerate, managed through an organization known as the Execution of Imam Khomeini's Order (EIKO) is reportedly worth $95 billion.[35]

EIKO's name refers to an edict issued by Khomeini shortly before his death in 1989 to manage and sell all property abandoned in the chaotic period following the 1979 revolution. From that original mandate, the network has grown into a vast business conglomerate – everything from agriculture to leisure resorts, parking lots and residential complexes. While EIKO is not part of the IRGC, it frequently partners with the IRGC-controlled companies. Like the Revolutionary Guards, it has an opaque, parallel, quasi-state power structure.[36]

EIKO's real estate portfolio is valued at $52 billion, and its stakes in publicly traded companies totaled $3.4 billion.[37] Through the Tadbir Group, which it uses for investment,[38] EIKO controls more than five percent of publicly traded companies on the Tehran Stock Exchange.[39] Rey Investment Company, which Treasury found is controlled by EIKO, was valued at $40 billion as of December 2010.[40] EIKO's publicly traded banks,[41] Parsian Bank and Karafarin Bank, are worth approximately $952 million[42] and $690 million[43] respectively.

Treasury designated EIKO and 37 of its Iranian and overseas subsidiaries in June 2013, noting that its purpose was "to generate and control massive, off-the-books investments, shielded from the view of the Iranian people and international regulators."[44] As then-Under Secretary for Terrorism and Financial Intelligence David Cohen explained, "Even as economic conditions in Iran deteriorate, senior Iranian leaders profit from a shadowy network of off-the-books front companies."[45]

Treasury sanctioned EIKO and its subsidiaries – including a number of foreign companies – under Executive Order 13599, which targeted Iran's government-owned entities for posing a threat to the integrity of the international financial system. As Treasury explained, EIKO was specifically "tasked with assisting the Iranian Government's circumvention of U.S. and international sanctions."[46]

U.S. sanctions had a chilling effect on EIKO's business ventures abroad, especially in Europe,[47] where an EIKO subsidiary unsuccessfully bid for a refinery in France in 2012, and in April 2015, another EIKO bid to buy a refinery in Switzerland was rejected, reportedly due to concerns over U.S. sanctions.[48]

As a result of the JCPOA, Treasury lifted sanctions on EIKO, despite the fact that none of these entities had been designated for nuclear proliferation,[49] but rather for involvement in illicit financial practices and corruption. There is no indication that this conduct has changed. The network, therefore, continues to pose risks to the integrity of the global financial system and remains a significant terror-finance risk.

Companies that EIKO likely established for the purpose of evading sanctions and helping Iranian procurement efforts are now likely to be subject to even less government scrutiny than before the JCPOA, thereby requiring greater company due diligence to ensure they are not opening themselves to significant business and reputational risk by engaging with EIKO.

Conclusion

Despite remaining hurdles, as of 2016 international companies are returning to Tehran in order to trade, build, and invest. They should carefully consider the risks discussed above before doing so and conduct enhanced due diligence about their customers, potential business partners, local contractors, and the financial conduits for payments. The likelihood of partnerships with IRGC-owned companies is high; and the concurrent risk of incurring future penalties is correspondingly high. The Iranian economy is now officially open for business. Its reputational risks and structural problems, however, have not diminished as a result of the nuclear deal signed last year.

Notes

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