Market-Based Reforms to the UK Economic Sanctions Regime

Professor David Collins

About the Author

Professor David Collins is a recognised authority on World Trade Organization law and international investment law, leads the Digital Trade Research Group at City Law School and is co-editor of the forthcoming Routledge Handbook on International Economic Law. He boasts a multifaceted legal career, having served as a prosecutor for the Attorney General of Ontario, and practices as a Solicitor in England & Wales, as well as being a member of both the Ontario and New York bar associations. As Co-Editor in Chief of "International Trade Law and Regulation" and Series Editor for Routledge's "Insights on International Economic Law," Collins has solidified his academic presence, supplemented by visiting academic positions at institutions like Columbia, Berkeley, and the Max Planck Institute. A recipient of grants from the British Academy and other scholarly councils, David contributes to the policymaking process through his roles in the Academic Advisory Councils of Politeia and the Institute of Economic Affairs, and as a Senior Fellow of the Macdonald Laurier Institute. Engaged in both academic administration and policy advisory, he has been nominated to international trade dispute panels, provided expert testimony to the UK's International Trade Select Committee, and has been integral to the UK's trade remedies authority. David is a Fellow of the Adam Smith Institute, having previously published *World Traders: the Case for UK membership of the WTO MPIA.*

Published in the UK by ASI (Research) Ltd.

23 Great Smith Street, London, SW1P 3DJ, 02072224995, info@adamsmith.org

FOREWORD

Sanctions are some of the most potent weapons in Britain's legal and foreign policy armoury. When Putin rolled his tanks into Ukraine, the British government led the way on system-wide sanctions and announced some of the strongest economic measures ever imposed, including trade restrictions and export controls. Our sanctions package has worked in concert with the military and financial support we are continuing to give to Ukraine to send a strong signal to the world that aggression against democratic nations will be resisted. I was proud to have backed a £3 billion export finance package for Ukraine in my own time as Chancellor.

But there are still improvements to be made to the UK's sanctions regime. Principally, we must do more to keep capital and business in the UK, driving economic growth here at the expense of hostile and aggressive states, rather than watching it leave altogether through sanctions evasion via shell companies and third-party states.

We should approach sanctions reform with renewed vigour. This new report from the Adam Smith Institute, which builds on its deep understanding of market economics, is an important contribution to the policy debate.

Under the 'compelled reinvestment' strategy it proposes, when an entity is sanctioned, rather than merely freezing their assets, we would mandate that they should instead be directed towards productive areas of the UK economy.

This new system would incentivise entities to keep their assets in the UK, rather than continuing to break sanctions restrictions, transforming it from a purely punitive system into one which actively benefits our economy.

However, as Professor David Collins rightly recognises, this will require careful consideration over how much interest or profit sanctioned entities would be allowed to receive from these investments. We cannot allow those who are directly culpable for, for example, human rights abuses in Ukraine, to profit.

I commend this report to all policymakers who are seeking to ensure that our sanctions regime achieves the UK's aims.

The Rt Hon Nadhim Zahawi
Former Chancellor of the Exchequer
August 2024

Executive Summary

- The UK's current sanctions regime is dysfunctional and is failing to place meaningful pressure on sanctioned regimes;
- This is exemplified by the failure to compel Russia to abandon its invasion of Ukraine;
- The intent of these sanctions was to damage the Russian economy by preventing funds from the West being used to finance their war efforts, but Russia's economy is expected to grow at a much faster rate than the UK's this year;
- Under our current system, businesses are effectively being forced back to the sanctioned regime. Those that remain are still managing to evade sanctions via shell companies or by operating through third-party countries, such as China and India;
- There are a host of other problems with our current sanctions regime, including a lack of coordination with the UK's international partners; insufficient resources for enforcement; difficulty in identifying and freezing assets; insufficiently punitive sanctions violation penalties, a lack of transparency, and a failure to provide proper guidance and support to businesses to ensure compliance with sanctions regulations;
- No policy-makers have yet figured out how to motivate sanctioned individuals and entities to keep their money within the West;
- This paper proposes the UK's sanction regime should be modified to compel sanctioned entities to re-invest in productive areas of UK economy, such as important infrastructure projects, rather than freezing their assets in place;
- This re-investment could take the form of loans to the UK Government, potentially with a small interest rate;
- Any profits from a successful investment project could be calibrated to the culpability of the sanctioned entity, with a zero-interest, no-profit category available for the very worst offenders;
- In order to prevent 'a race to the bottom' in which countries compete for the investment of those they have sanctioned, to the potential benefit of the sanctioned, the new investment arrangement could be agreed upon by all participating sanctioning states.

Introduction: The UK's Failing Sanctions Regime

The UK's current sanctions regime is dysfunctional, as exemplified by the failure to place meaningful pressure on Russia to abandon its invasion of Ukraine. The intent of these sanctions was to damage the Russian economy by preventing funds from the West being used to finance the Russian war effort in Ukraine. Yet, more than two years on from the invasion, the Russian economy is not slowing, nor is there any indication that international markets for its arms and energy have dissipated. The IMF has even revised their projections for growth in the Russian economy this year, up to 3.2% GDP growth.[1] Part of Russia's resilience to Western sanctions may be explained by smuggling and sanctuary in third-party countries, such as China and India. Irrespective of the reasons for their failure to achieve deterrence, the sanctions imposed on Russia have inflicted harm on British markets. In many respects, not only have the economic sanctions against Russia failed to achieve their aim; they have actually been self-defeating. Western markets continue to struggle, having cut off one of their most significant trading partners.

The sanctions that have been implemented in the West have paradoxically led to a situation in which businesses have been effectively forced back to Russia since they have been rendered incapable of doing business in the West. Unfortunately for the UK and the West, the very people who know how to build and sustain businesses, to innovate and generate wealth, are engaging in these activities in Russia rather than in the West, where they had previously chosen to run their businesses. Of course, individuals who are complicit in supporting the Russian war effort should not be excused on economic grounds. Yet the current sanctions regime is having a perverse effect in terms of economic benefits and punishment. It is the UK which has been 'punished' and Russia which has benefited.

Changes to the UK's sanctions regime have been minor, merely tightening up compliance and accountability measures. In February 2024, the UK government published its first sanctions strategy, setting out how sanctions are used as a foreign and security policy tool. This involved reinforcing all aspects of the government's sanctions activity, strengthening capability and legislation, enhanced collaboration across government; and invested further in sanctions implementation and enforcement.[2] The policy further references "minimising unintended consequences from sanctions within the UK and globally" ... "to address implications for businesses and for the UK and global economy".[3]

1 IMF <https://www.imf.org/en/Countries/RUS> (April 2024)

2 "Deter, disrupt and demonstrate – UK sanctions in a contested world: UK sanctions strategy" UK Government, (22 Feb 2024)

3 Ibid at 4

While they may have helped generate some efficiencies and minimise adverse impacts from sanctions, these are essentially superficial changes. In the UK, it remains legal for sanctioned individuals to receive rental payments or dividend payments if they own less than 50 percent of a company and are disempowered of British stock. These failings illustrate a lack of appreciation regarding how sanctions could be implemented in a way that would genuinely prevent Western funds supporting the Russian war effort. Under the current system, sanctions evasion still occurs. Businesses have been able to use various strategies to deliver goods to Russia through international waters for example by shipping via neutral third states or by selling dual use resources, such as metals or electronics. No policy makers have contemplated how to create an environment where these individuals are motivated to keep their funds and, consequently, the value they add to the economy, within the West.

It is a source of continued dismay that the UK sanctions regime is simultaneously not strong enough to discourage investments in sanctioned countries (and thereby discourage belligerent behaviour) yet sufficiently strong to discourage investment in the sanctioning countries. A key explanation for this apparent contradiction is that the UK's current sanctions regime does not offer any positive incentives, only negative ones. Classical economics informs us that rational actors will take decisions to maximise their welfare based on cost-benefit analysis, including the cost of lost opportunities. This logic has not been used to beneficial effect to fulfil UK foreign policy goals, in part by harming states which do not comply with international law, and simultaneously stimulating domestic economic growth.

Positive incentives, sometimes described as 'carrots' as opposed to 'sticks,' are among the most powerful mechanisms in driving compliance with law, especially international law for which there is no centralised law-making authority. The positive externalities of complying with the law are an important element of what makes laws robust.[4] In other words, laws are obeyed because doing so generates benefits for the individual as well as for society at large. Self-interest makes people more likely to be good citizens. A self-interested profit-making incentive could be even more influential in dictating an individual's or firm's behaviour. Indeed, Adam Smith himself wrote of how a person's sense of well-being is achieved through the aspiration to become something better.[5] Enlarging the profit-making capacity of one's business activities would fit within this goal.

Poorly designed sanctions regimes, coupled with a lack of flexibility for those who want to exit from a sanctioned country or who seek to engage in legitimate business leads to a greater lack of compliance. Failure to administer sanctions adequately will have a deleterious effect on the UK economy with no real achievement in foreign policy aims in terms of curtailing breaches of international law, as identified by the UN Security

4 Tom Tyler, Why People Obey the Law (Princeton University Press, 2006)

5 See Erik Matson, 'New Paternalism Meets Older Wisdom' Institute for Economic Affairs at 50-51

Council and others. UK economic sanctions have not made a meaningful impact on Russian President Vladimir Putin's war machine. They are difficult to administer and leave Britain more vulnerable than before without offering meaningful resolution to the war in Ukraine. Reform of the UK's sanction regime is necessary, and a market-based solution may be the most effective strategy.

Since the sanctions regime does not currently function optimally in achieving the UK's aims, in economic growth and in the maintenance of peace, this report proposes a new solution to the sanctions regime dilemma. Asset freezes and investment bans on sanctioned entities and individuals offer little incentive to change behaviours. Total divestment in stocks, entities, and institutions is difficult to achieve, but given the right incentives (through a reformed sanctions regime) to shift capital from sanctioned countries to the UK, we would see greater capital inflows at the cost of sanctioned nations. In other words, the sanctions regime could not only punish the offending, sanctioned state, but also benefit the imposing, sanctioning one.

A strict enforcement regime, through the Office of Financial Sanctions Implementation (OFSI), should remain that maintains the power and authority of sanctions, while achieving the correct incentives to maintain access to the UK's liberal, open market economy for those wishing to relinquish residency in other nations. Such a change to the sanctions regime would place the UK at the forefront of global sanctions regimes in offering a solution to transfers of assets while not taking a geopolitically irresponsible stance of neutrality on pressing global issues, such as the peace and security of its allies. Alignment with EU and US sanctions regimes, the latter of which has been the most effective in terms of its strategic aims, remains a key obligation in Westminster.

The sanctions reform proposal outlined here would enable compliance with the UK's treaty obligations while offering a more dynamic means of responding to future crises in a manner that does not inflict harm on the domestic economy. Despite recent reforms to non-domiciled taxpayers, as announced in the 2024 Spring Budget, the Harrington Review sets out the UK government's commitment to widening greenfield investment. Unstable economies, such as those in Russia or Iran, are optimal sources from which investment can be transferred to the UK at the expense of the sanctioned state. The new sanctions system would provide a clear advantage to the UK and ensure its prosperity at the expense of our regional and global foes.

The broader context of the UK's current economic status must also be considered as a backdrop. While the UK continues to be a world-leading destination of foreign direct investment,[6] it cannot be assumed that this will continue, particularly during an era of high taxation. Nor can it be presumed that the foreign direct investment which the UK does receive is the kind that it actually needs, e.g. that which yields infrastructure

6 Office for National Statistics reported that in 2021 and 2022 the UK overtook China to become the second-highest destination country for FDI behind the US.

and long-term employment, rather than merely 'hot money.' Presenting the UK government with capital that could be put to the best use for the economy at large, especially where it is coupled with the expertise of successful foreign investors, should be of great interest to any government.

II - Economics Sanctions
An Overview

Economic sanctions are measures that are imposed by certain states and/or international organisations in order to elicit a change in the behaviour of the target.[7] Traditionally, they were imposed by the sanctioning state against other states and/or against non-state actors (e.g. firms) located in the target state.[8] Sanctions are imposed in part because of international security concerns and the need to safeguard the territorial sovereignty of states from the threat of encroaching states. For example, immediately after Russia's invasion of Ukraine, multiple sanctions regimes were imposed against Russia. Those were mostly unilateral (either by individual states, such as the US, or by regional supranational organisations, such as the EU).[9]

As with UN, EU and US sanctions, UK sanctions take a wide variety of forms, and these are constantly being modified in response to changing international circumstances. Most UK sanctions measures can be broadly divided into two categories: (i) financial sanctions, or sanctions relating to blocked assets; and (ii) transaction controls, including trade restrictions and investment bans.[10] This covers both sanctions which are imposed against foreign investors committing their capital to UK territory, an activity which would be almost impossible in the event that economic sanctions are in place, but also to sanctions imposed by the home state that seek to prohibit the transfer of capital by domestic investors. It could further apply extraterritorially, in the case of secondary sanctions imposed on a sanctioned state,[11] for example Iran.

The sanctions imposed against Russia following its invasion of Ukraine were imposed on an unprecedented scale. They involved asset freezes against Russian leadership, including business and political elites; measures targeting the financial system, directed against banks and financial institutions (an important number of them operating transnationally); energy sanctions, including sanctions levied against *Nord Stream 2*.[12] Economic sanctions may also be viewed as a tool of economic statecraft, where the lines between measures undertaken for security reasons and measures taken as part of war are blurred.[13]

---

7 Dapo Akande, Payam Akhavan and Eirik Bjorge, "Economic Sanctions, International Law, and Crimes Against Humanity: Venezuela's ICC Referral", 115(3) The American Journal of International Law 493 at 493

8 Henry Farrell and Abraham L. Newman, "Weaponized Interdependence: How Global Economic Networks Shape State Coercion"m44(1) International Security (2019) 42 at 42

9 Elena Chacko and J. Benton Heath, "A Watershed Moment for Sanctions? Russia, Ukraine, and the Economic Battlefield," 116 AJIL Unbound (2022) 135 at 136

10 Richard Gordon, Michael Smyth, and Tom Cornell, Sanctions Law (Hart Publishing 2019) at115

11 Tom Ruys and Cedric Ryngaert, "Secondary Sanctions: A Weapon Out of Control? The International Legality of, and European Responses to, US Secondary Sanctions," The British Yearbook of International Law (2020); Ruys and Ryngaert refer to US sanctions in particular.

12 Chacko and Heath, supra n 9, 135-6

13 Ibid at 139

Sanctions may be a response to "actions deemed reprehensible by the international community."[14] This premise assumes the existence of an international community and of community values in international relations and international law. This concept could encompass interests reflected in *jus cogens norms* (those from which no derogation is permitted) and obligations *erga omnes* (obligations owed towards all, the respect of which matters to the international community as a whole and which can be enforced by anyone).[15] This could include international norms such as freedom from torture and the prohibition of racial discrimination.[16] Such values arguably originate from more fundamental ones, such as the pursuit of peace, human rights, self-determination, the rule of law, or democracy.[17] There is also a moral element underpinning economic sanctions.[18] They are a form of enforcement in international law,[19] which is characterised by a decentralised legal system and for which compliance is problematic but essential for the maintenance of healthy relations between states, for which international law is often viewed as a cornerstone.

The global sanctions database[20] lists nine objectives of sanctions: changing policy, destabilising regimes, resolving territorial conflict, fighting terrorism, preventing war, ending war, restoring and promoting human rights, restoring and promoting democracy, and other objectives.[21] For the UK, economic sanctions are implemented with the following goals in mind: undermining Russia's ability to fund and wage its war against Ukraine, including by cracking down on efforts to get around sanctions; addressing threats and malign activity through geographic and thematic sanctions regimes; building international coalitions and take co-ordinated action with allies and partners to maximise the impact of our sanctions while deepening engagement with business, financial institutions and other stakeholders; reinforcing sanctions implementation and enforcement, including by helping UK businesses to understand and comply with sanctions and by taking robust action on non-compliance.[22]

Clearly then sanctions can also be used for purely political purposes, such as destabilising hostile regimes or undermining their expansionist agendas. Much as some sanction regimes were deployed in order to protect the values of the international order, such as territorial sovereignty, nuclear non-proliferation, or the territorial integrity of a state, there are also examples where sanctions are used as purely political tools to

14 Wenjie Yu, "China's Emerging Unilateral Sanctions: Heading Towards the Rule of Law," 9(3) The Chinese Journal of International Law (2021) 359 at 360

15 Jure Vidmar, "International Community and Abuses of Sovereign Power," 35 Liverpool Law Review (2014) 193 at 205.

16 Ibid at 207

17 Isabel Feichtner, "Realizing Utopia through the Practice of International Law," 23(4) The European Journal of International Law (2012) 1143 at 1150

18 See generally, Laetitia B. Mulder, "When Sanctions Convey Moral Norms," 46 European Journal of Law and Economics (2018) 331.

19 Julia Schmidt, "The Legality of Unilateral Extra-territorial Sanctions under International Law," 27(1) Journal of Conflict & Security Law (2022) 53 at 76-7

20 https://www.globalsanctionsdatabase.com/ (accessed June 2024)

21 T. Clifton Morgan, Constantions Spyropoulos, and Yoto V. Yotov, "Economic Sanctions: Evolution, Consequences, and Challenges," 37(1) Journal of Economic Perspectives (2023) 3 at 4

22 Deter, disrupt and demonstrate – UK sanctions in a contested world: UK sanctions strategy' (22 Feb 2024) at 4 destabilise political adversaries, for example, the Cuba embargo,[23] in the context of US measures against the Castro regime.[24] Sanctioning states will not always concede these objectives. For instance, when imposing sanctions against *Nord Stream 2*, the US claimed that it was acting to safeguard energy security in Europe.

In terms of the effectiveness of sanctions, it is perhaps unsurprising that there is compelling evidence that investors pull out of countries targeted for sanctions prior to their imposition. This disinvestment is not permanent, however, and investment tends to return after the sanctions are imposed.[25] On the other hand, there is strong evidence that when firms disinvest in response to sanctions, global FDI significantly increases, providing the target country with a reliable source of capital replacement. This suggests that there is limited effectiveness of sanctions for restricting capital flows to targeted countries. Firms from the sanctioning state may ultimately bear the highest costs from sanctions imposed by their home state.[26]

There are negative externalities associated with sanctions programs. One study revealed that sanction exerts a detrimental effect on the total inflows of FDI. Regarding different types of sanctions, while military and trade sanctions have little or even no impact on greenfield investment, they have more adverse and sizable effects on cross-border mergers and acquisitions. Worse, sanctions exert devastating influences through the infrastructure and economic development channels.[27] Another study showed that sanctions have varied effects on FDI flows. They significantly reduce FDI flows before and during the crisis period. The consequences of sanctions on FDI flows become more severe in the presence of global value chains and global bank linkages. Global Value Chains enhance the negative impacts of trade sanctions whereas Global Business Licences affect FDI flows more significantly.[28]

Studies show a high failure rate for sanctions which are often undermined by third-party countries that continue to trade with the targeted nation, reducing the effectiveness and potentially harming the imposing country's economic interests.[29] Sanctions might backfire by shifting the target's spending towards contentious policies rather than mitigating them.[30] The collective evidence indicates that while sanctions can be a tool for applying pressure, they often have complex and unintended consequences that

23 Daniel Drezner, "How not to Sanction," 98(5) International Affairs (2022) 1533, 1534

24 Yu, supra n 14, 362-3. See Agathe Demarais, Backfire. How Sanctions Reshape the World Against U.S. Interests (Columbia University Press, 2022), at 3-4

25 Biglaiser G, Lektzian D. "The Effect of Sanctions on U.S. Foreign Direct Investment" International Organization. 2011;65(3):531-551. doi:10.1017/S0020818311000117

26 David Lektzian, Glen Biglaiser, "Investment, Opportunity, and Risk: Do US Sanctions Deter or Encourage Global Investment?" International Studies Quarterly, Volume 57: 1, March 2013, at 65–78, https://doi.org/10.1111/j.1468-2478.2012.00761.x

27 Loan Quynh Thi Nguyen, Rizwan Ahmed, "The impact of economic sanctions on foreign direct investment: empirical evidence from global data" Journal of Economics and Development Vol. 25 No. 1, at 79-99; ISSN: 1859-0020

28 TH Le, & NT Bach, (2022). "Global sanctions, foreign direct investment, and global linkages: evidence from global data." Journal of International Trade & Economic Development, 31(7) 967–994. https://doi.org/10.1080/09638199.2022.2047218

29 Bryan Early, Busted Sanctions: Explaining Why Sanctions Fail (Stanford University Press, 2015)

30 T Kustra, (2023). Economic sanctions as deterrents and constraints. Journal of Peace Research, 60(4), 649-660. https://doi.org/10.1177/00223433221088323 may undermine their efficacy and harm the economies of both the target and the imposing countries. This is precisely why positive incentives are needed: sanctioned entities need to be encouraged to divert their business activity into the sanctioning state or into allies' markets. The potential to generate profit within the sanctioning state is precisely such an inducement.

III - The UK's Sanctions Regime and its Weaknesses

The UK implements a range of sanctions through regulations made under the Sanctions and Anti-Money Laundering Act (the Sanctions Act)[31] which provides the main legal basis for the UK to impose, modify and remove sanctions. Regulations made under the Sanctions Act apply to conduct by UK persons. This includes anyone in the UK (including its territorial waters), UK nationals outside of the UK, and bodies incorporated or constituted under the law of any part of the UK. The UK may impose the following types of sanctions: trade sanctions, including arms embargoes and other trade restrictions; financial sanctions, including asset freezes; immigration sanctions (travel bans); and aircraft and shipping sanctions, including de-registering or controlling the movement of aircraft and ships. Some kinds of sanctions, such as asset freezes and travel bans, apply only to persons or ships which have been designated or specified by the UK Government. This is set out in the UK sanctions list.[32]

OFSI, which is part of Treasury, maintains a Consolidated List of Asset Freeze Targets. This contains details of entities which are subjected to financial sanctions. Financial sanctions include restrictions on designated persons, such as freezing their financial assets, as well as wider restrictions on investment and financial services. OFSI assists businesses in understanding their financial sanctions obligations. It also monitors compliance and assesses suspected breaches. OFSI can issue licences to allow for an activity that would otherwise be prohibited by financial sanctions regulations.

Trade sanctions are implemented by the Department for Business and Trade (DBT). Trade sanctions can include prohibitions on the import, export, transfer, movement, making available or acquisition of goods and technology; the provision or procurement of services related to goods and technology; the provision or procurement of certain other non-financial services. DBT's Export Control Joint Unit manages the UK's system of export controls in relation to trade sanctions whereas DBT's Import Licensing Branch implements trade sanctions relating to imports.

Transport sanctions are administered by the Department for Transport, covering the aviation and maritime sectors. Transport sanctions include restrictions on the ownership, registration or movement of ships and aircraft. This can include restrictions on movements to and from ports, harbours and airports, and the detention of ships and aircraft. Immigration sanctions, also known as travel bans, are implemented and enforced by the Home Office. Individuals subject to travel bans will be refused leave to enter or remain in the UK. Foreign nationals who are subject to a travel ban, and who are currently in the UK, have their permission to stay in the UK cancelled.

31 Sanctions and Anti-Money Laundering Act, 2018 c.13

32 FCDO, The UK Sanctions List, last updated: 26, June 2024.

The Sanctions Regulations establish exceptions to some of the sanctions prohibitions which apply within certain defined circumstances. Moreover, licences may be issued for certain activities that trade sanctions measures would otherwise prohibit. For example, individuals or businesses may apply for an import licence from DBT's Import Licensing Branch or to the Export Control Joint Unit. Licences may also be issued to permit activities that financial sanctions restrictions would otherwise prohibit. Licences issued by OSFI. Licences may be issued for activities that transport sanctions or immigration sanctions would otherwise prohibit.

The UK's current economic sanctions regime is in disarray, failing to achieve its intended goals. There are several reasons for this dilemma. First, there is a lack of coordination with the UK's international partners. The UK's sanctions policies are poorly aligned with those of major allies like the US and EU. Sanctioned entities can exploit this lack of coordination, for example by shipping through third countries. Indeed, divergences between the sanctions regimes of major powers are believed to create opportunities for evasion and undermine the overall impact of restrictive measures. The UK's departure from the EU has arguably exacerbated this issue, as it no longer automatically aligns with EU sanctions.[33] The need to transpose EU sanctions into UK law following Brexit has led to delays and inconsistencies. This is thought to have generally complicated the UK's sanctions policymaking and implementation processes, reducing the coherence of its sanctions actions to the point of ineffectiveness.[34]

Insufficient resources for enforcement are another serious shortcoming of the UK's sanctions regime. OFSI lacks adequate staffing and funding to effectively monitor compliance and investigate potential violations. Alarmingly, a 2022 report by the House of Commons Foreign Affairs Committee found that OFSI is under-resourced and lacks the capacity to properly enforce the UK sanctions regime.[35]

Furthermore, the UK tends to focus heavily on financial sanctions, such as asset freezes, while neglecting other tools like trade restrictions or travel bans. This narrow, myopic approach limits the overall impact of sanctions. Commentators have persuasively argued that an overemphasis on financial measures at the expense of other types of sanctions can reduce the coercive effect of a sanctions program.[36] The UK has fallen into this trap.

Exacerbating this problem, the UK government further struggles to identify and freeze assets belonging to sanctioned individuals and entities, particularly those hidden through complex ownership structures or held in cryptocurrency. The National Crime Agency has highlighted the difficulty of tracing assets, observing that identifying and

33 C Portela, (2021). "Transatlantic Cooperation on Sanctions in Latin America: From Convergence to Alignment?" Atlantic Council

34 E Moret, (2021). "Sanctions and Brexit: Challenges and Opportunities for UK Sanctions Policy" RUSI Journal, 166(3) 42-54

35 Foreign Affairs Committee, 2022

36 R Nephew, The Art of Sanctions: A View from the Field. (Columbia University Press, 2018) freezing cryptoassets linked to sanctioned persons presents significant technical and legal challenges.[37] It is hard to see how the UK will ever be able to address this failing given the increasing usage of untraceable payment methods like cryptocurrencies.

The penalties for breaching UK sanctions are often not severe enough to deter non-compliance. The maximum civil monetary penalty that OFSI can impose is a mere £1 million or 50 per cent of the value of the breach, whichever is higher. For some entities, this may be viewed as an acceptable cost of doing business. It is widely acknowledged that when sanctions violation penalties are insufficiently punitive, they fail to create adequate incentives for compliance.[38] Incredibly, the UK government does not appear to have grasped this basic point.

The lack of transparency is yet another problem with the UK's sanctions regime. There is limited public reporting on the implementation and impact of UK sanctions, making it difficult to assess their effectiveness and hold authorities accountable. A 2022 Foreign Affairs Committee report called for greater transparency in the sanctions designation process and more regular public reporting on sanctions enforcement activities.[39] Rather than confront the current regime's failings, the UK approach appears to have been to obscure the problem, putting it beyond reach of those who are in a position to rectify it.

Add to this, the UK's sanctions regime is plagued by a tendency to insufficiently engage with the private sector. In particular, the government has not provided adequate guidance and support to businesses to ensure compliance with sanctions regulations. This has led to confusion and potential unintended violations, penalising entities that are going about their business lawfully. Worryingly, a survey by UK Finance in 2021 found that 70 per cent of financial institutions reported difficulties in interpreting and applying UK sanctions regulations.[40] This is an outrageous state of affairs that must be resolved.

There has been limited use of Magnitsky-style sanctions, which are sanctions imposed on foreign individuals who have committed human rights abuses or been involved in significant corruption. While the UK has introduced a global human rights sanctions regime, it has been slow to utilise these powers extensively. One report noted that, as of 2022, the UK had only designated seventy-two individuals and six entities under its global human rights sanctions regime, compared to over 1,000 designations by the US under its similar programme.[41] It appears as though the UK government has been asleep at the wheel.

37 National Crime Agency, 2021.

38 BR Early, B. R., & K Preble, K. (2020). "Enforcing Economic Sanctions: Analyzing How OFAC Punishes Violators of U.S. Sanctions." Foreign Policy Analysis, 16(3), 397-416

39 Foreign Affairs Committee, 2022.

40 UK Finance. (2021). Sanctions Compliance Survey 2021.

41 Foreign Affairs Committee, 2022.

Finally, sanctions evasion has been a perennial problem for the UK government. The UK has struggled to effectively counter sophisticated sanctions evasion techniques, such as the use of shell companies or third-country intermediaries. The National Crime Agency (2021) has highlighted this as a growing concern, reporting that sanctions evasion schemes are becoming increasingly complex and difficult to detect.[42] While this may be true, it is baffling that a country with the resources and sophistication of the UK has neglected to address this issue.

42 National Crime Agency. (2021). National Strategic Assessment of Serious and Organised Crime 2021.

IV - The Proposal: Compelled Re-Investment in the Sanctioning State

Using economic sanctions to force companies owned by sanctioned individuals to invest in the sanctioning state is a less conventional application of sanctions. Still, the proposal has the potential to generate economic benefits for the UK in addition to placing pressure on sanctioned entities to alter their conduct. The re-investment proposal will now be outlined.

UK sanctions legislation would be modified to enable the requirement for designated sanctioned entities to put their investments held in the sanctioned state to productive use for the UK economy, rather than merely be frozen in place as is the conventional effect of sanction measures. This 'compelled re-investment' into the sanctioning state (in this case the UK) would be passive in nature with respect to the sanctioned entity itself (the individual or corporate entity). It would not require ongoing managerial involvement on the part of the sanctioning entity, nor would it require expertise or even familiarity with the chosen sector or industry. This approach is consistent with the common-law rule against specific performance of a personal services contract.[43]

The entity affected by such a measure may not be the direct target of the sanctions regime, but the target of secondary sanctions or a national of the sanctioning state (e.g. a UK investor who is under an obligation to commit its capital to the UK because it either invested in a sanctioned jurisdiction or because it had business relations with a sanctioned entity). If an individual were to violate this sanctions regime by investing (or maintaining an investment) in a sanctioned jurisdiction or by entering into or maintaining relations with a sanctioned entity, that individual would be presented with a choice: 1) face the typical consequences of violating a sanctions regime (criminal penalties, not being granted access to the sender's market) or 2) re-investing that capital in the sanctioning state or using the proceeds that it derived from the investment to invest in the sanctioning state. It is this second element that forms the novel element of this proposal. Alternatively, option 2) could be presented as mandatory – hence 'compelled re-investment'.

The mechanism would operate in general terms – it would involve merely having to commit capital to the sanctioning jurisdiction rather than commit in any particular form / sector. Once identified by the OFSI, the UK government would be able to channel the sanctioned funds into whatever investment vehicle or project was desired in order to maximise its economic benefit to the British public. Given that there would be no managerial oversight by the sanctioned entity, the funds could even

43 Johnson v Unisys Ltd [2001] UKHL 13 be used for critical infrastructure or other sectors which would conventionally be restricted to foreign investors for national security reasons. Review under the National Security Investment Act[44] would not be necessary. As with any public investment, periodic reviews would be undertaken to assess the performance / effectiveness of the investment. In the event that the sanction measure was lifted, a process would be in place enabling the original sanctioned entity to recover their funds, either in full or partially and potentially with a profit, were this deemed appropriate.

The proposed regime could require the sanctioned entity to commit to maintaining, or even expanding, an already made investment in the UK. In other words, the UK government might ascertain that the most productive use of the funds would be to enable them to remain in the UK in their current form. This could be construed as an expropriation, of which more below. If in such circumstances it was deemed suitable for the sanctioning entity to retain a managerial or operational role in the reinvestment, then national security screening would unquestionably apply. FDI screening for national security purposes has become commonplace, indeed it is often viewed as an essential manifestation of a state's national security strategy. Non-passive investment in the UK would most likely be only permitted in non-strategic sectors.

The re-investment could take the form of government bonds, i.e. loans from the sanctioned entity directly to the UK government, potentially bearing a small interest rate over a long term, potentially calibrated to the duration of the relevant geopolitical event, for example until the Russia-Ukraine conflict is resolved to the satisfaction of the international community. The funds could be used at the treasury's discretion for public spending as needed. As bonds, the obligation would rest on the government to repay the principle to the investor, arguably addressing the moral argument against the compelled investment, more so in the event of interest payment.

On the other hand, the payment of interest (or eventual profit) to the sanctioned entity could raise the moral issue of the sanctioned entity profiting from their misdeeds (i.e. their role, directly or otherwise, in the geopolitical conflict which led to the sanction in the first place). This aversion is reflected in certain domestic laws which forbid providing assistance to sanctioned entities, e.g. the US law against providing material support to terrorists, which applies notwithstanding constitutionally enshrined protections for free speech.[45] The interest rate payable on the bond, or any profit stream derived from a successful project, could be calibrated to the perceived culpability of the sanctioned entity and / or the severity of the geopolitical crisis, with a zero-interest, no-profit category available for the worst offenders. In the case of bonds, changes may be required to the Financial Services and Markets Act[46] which

44 National Security and Investment Act, 2021 c. 25

45 Holder v Humanitarian Law Project, 561 U.S. 1 (2010) (US Supreme Court). Under US law broad range of interactions with designated terrorist groups, including attempts at peace building and support for non-violence, are prohibited (18 U.S.C. § 2339B)

46 Financial Services and Markets Act 2000 c.8, ss 89A-89G regulates the bond market in order to integrate this into the compelled re-investment proposal. The Financial Conduct Authority, which oversees the functioning of financial markets, would presumably also retain a role here.

There could also be a situation where the sanctioning state imposes sanctions on a target state and the latter imposes counter-sanctions, as Moscow contemplated doing against Western companies divesting from Russia. In this case, the proposed sanctions regime might actually be beneficial to the foreign investor. The investor would be afraid to divest itself from Russia (for example) because it could lose everything by facing a countersanction. Re-investing in the sanctioning state (the UK) might offer a reasonable alternative.

The effect of the compelled reinvestment regime on the UK's international investment treaties, known as International Investment Agreements (IIAs) would have to be considered. In particular, the expropriation and free transfer provisions of these instruments would need to be addressed. The UK has more than one hundred IIAs which provide legal safeguards to foreign investors against arbitrary actions by the government, such as discrimination or seizure of assets without compensation.[47] Seizing a productive asset, including any profit stream derived from it, as would be the case in the compelled re-investment proposal, could be construed as a form of expropriation, as this concept tends to be broadly understood. Expropriation, when it is done for a public purpose, requires the payment of compensation to the affected party, typically assessed at the full market value of the asset at the time of seizure. [48]

IIAs also contain free transfer of currency and capital provisions which enable foreign investors to move their money out of host states.[49] This includes profits derived from their foreign investor. Thus, freezing or seizure of assets to be reinvested at the government's behest, could also amount to an IIA violation. Thankfully, however, most IIAs, including all of those concluded by the UK contain 'essential security' clauses which enable host states to undertake these measures without legal consequence. For example, the Comprehensive Progressive Trans Pacific Partnership (CPTPP) contains the following provision which applies to the entirety of the treaty:

> "Nothing in this Agreement shall be construed to: (a) require a Party to furnish or allow access to any information the disclosure of which it determines to be contrary to its essential security interests; or (b) preclude a Party from applying measures that it considers necessary for the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests."[50]

47 E.g. UK-New Zealand FTA Art 14.14

48 See D Collins, Introduction to International Investment Law (2nd ed. Cambridge University Press, 2023)

49 E.g. UK-New Zealand FTA Art 14.13

50 Art 29.2

While this provision is framed in 'self-judging' language and as such entails the broadest conceivable discretion on the part of the state party enacting a measure, there is a plausible argument to be made that while the sanction itself is within the UK's essential security interest, the compelled re-investment is less of an essential security interest and more of an economic one. In other words, while the UK could likely not be challenged in an investment arbitration tribunal for imposing a sanction which amounted to a breach of the expropriation or free transfer provisions of an IIA (e.g. a conventional asset freeze), the compelled re-investment element of the sanction might be viewed as excessive. Still, very few arbitration tribunals have been willing to question breaches of essential security clauses. One way to mitigate against the risk that a sanctioned investor could bring a successful claim in investment arbitration against the UK for breach of an IIA would be to direct a portion (if not all) of any ensuing profits from the re-investment project back to the investor. Of course, this raises the moral issues noted earlier concerning sanctioned entities earning profits despite their adverse conduct.

While there are not many clear precedents for sanctions directly compelling investment, there have been cases where sanctions influenced corporate behaviour indirectly: US sanctions led many multinational companies to pull out of Iran, and in some cases, they redirected their investments to other regions, including the US. During the Cold War, sanctions sometimes led companies to relocate operations from the Soviet bloc to Western countries due to the political and economic pressures. There is precedent, however, for sanctioned assets to be used for other purposes rather than merely frozen. For example, in 2024, leaders of the G7 agreed to use the profits of frozen Russian assets to secure a loan of approximately $50 billion in aid to Ukraine.[51] Re-directions of sanctions has even led to sanctioned-individuals gaining profit. In another recent example, Israeli billionaire Dan Gertler, who was placed under sanctions for alleged corruption for mining investments in the Democratic Republic of Congo, is set to receive as much as US$300 million in profit on condition that he sells his remaining mining interests in the country. The US Treasury will provide Gertler with a special licence to sell his royalty streams back to the Congolese government, after which point he will be granted a general licence to regain access to the US financial system.[52] Additionally, the EU recently approved a plan through which the profits generated by frozen Russian assets will be used for the reconstruction of Ukraine.[53]

The compelled re-investment proposal resembles a strategy undertaken by some sanctioning countries in anticipation of the economic harm which may result from the imposition of sanctions. Combining sanctions with an economic strategy in which the sanctioning country opens up specific sectors for investment, could make it

51 'G7 strikes provisional deal on using Russian assets for $50B Ukraine loan' Politico, 13 June 2024

52 'Billionaire under sanctions could get $300mn in controversial US-Congo deal' The Financial Times (16 June 2024)

53 Council of the European Union, "Extraordinary Revenues Generated by Immobilised Russian Assets: Council Greenlights the Use of Net Windfall Profits to Support Ukraine's Self-Defence and Reconstruction" (accessed June 2024).

attractive for all foreign companies to shift their focus to the sanctioning country. Enlarging foreign investment generally is a means of mitigating the harmful effects of sanctions on the sanctioning state.

The sanctioning country could offer incentives or relief to companies willing to invest within its borders. For example, the UK might offer tax breaks or subsidies to foreign companies indirectly affected by sanctions (for example if there are sanctioned companies within their supply chains) if they relocate their operations or investments to the UK. Investment incentives are generally permitted under international law, provided that they are not linked to trade distorting practices such as local content performance requirements.[54]

It should be noted here that, depending on the nature of additional incentives, compelled-reinvestment into the sanctioning state on its own would probably not constitute an illegal subsidy to the sanctioned entity, under the World Trade Organization (WTO's) Agreement on Subsidies and Countervailing Measures. While it would enable the entity to avoid the fine normally associated with a sanction, it would not constitute a 'financial contribution' such as a loan, grant or transfer of funds.[55] Precluding the application of the fine might constitute 'government revenue that is otherwise due', although this is typically associated with tax relief.[56] For such a measure to be challenged through the WTO dispute settlement system there would need to be a distortive effect on trade in goods arising from the measure.

54 See D Collins, Performance Requirements and Investment Incentives under International Economic Law (Elgar, 2015)

55 ASCM Art 1.1 a) i

56 ASCM Art 1.1 a) iii

V - Refining the Proposal: Multilateralising Compelled Re-Investment Sanctions

One of the dangers of the proposal to compel reinvestment of sanctioned assets into the UK is that this regime could be adopted by other countries, including the UK's allies, resulting in a 'race to the bottom' in which sanctioning countries compete for investment from the entities which they have sanctioned. This problem would be exacerbated in the expected situation wherein various Western countries shared common geopolitical purposes and therefore duplicated sanctions. Indeed, sanctions are believed to be more effective when they are imposed by a multitude of countries, rendering avoidance more difficult. This dilemma is predicated on the notion that the sanctions proposal envisioned here will offer positive incentives to sanctioned entities, i.e. it would make investing in the sanctioning state attractive from an economic perspective. This is problematic because investment incentives may ultimately be economically harmful, especially when they are of a magnitude designed to out-compete those offered by other countries. Sometimes described as the 'winner's curse' investment incentives, much like subsidies, are often economically inefficient in the long-term.[57]

In one sense a 'market for sanctions' or more accurately, a market for re-investment of sanctioned assets, is precisely the outcome that should be sought by this proposal. The pursuit of economic efficiency dictates that assets should be channelled to the uses for which they are most productive. Flowing from this, the countries which offer the best environment for foreign investment not only morally deserve to receive that investment, they are likely to make the most socially productive use of it. But in the case of compelled reinvestment, competition among sanctioning states could cause them to offer incentives to sanctioned entities, such as tax breaks or wider exemptions in terms of the application of sanction measures to relevant assets or individuals. As the UK and its allies compete to attract this kind of FDI, the sanctioned entity might end up benefiting from their impugned behaviour (e.g. invading sovereign nations). The sanctioned entity would be able to play each country off against each other, getting the best deal. This is possible because states, like people, tend to behave opportunistically, seeking to maximise their welfare through their actions, sometimes at the expense of other states.[58]

Should this eventuality be viewed as undesirable, one way to prevent sanctioning states from adding incentives to attract FDI from sanctioned parties would be to multilateralise the reinvestment arrangement. Participating states would agree not to

57 R Thaler, "Anomalies: The Winner's Curse" 2:1 Journal of Economic Perspectives 191 (1988)

58 Tomer Broude and Anna van Aaken, "Behavioral Economic Analysis of International Law," in Eugene Kontorovich and Francesco Parisi (eds.), Economic Analysis of International Law 249-275 (Cheltenham: Edward Elgar, 2016) offer incentives to sanctioned investors beyond some minimum threshold. Effectively colluding to prevent an upward spiral in incentives which could be self-defeating, participating states would agree to permit re-investment in any participating country as an alternative to facing the conventional sanction fines. Much as sanctions tend to be applied by multiple countries as a combined effort, this would eliminate reinvestment competition, maintaining a united front against the geopolitical foe. This is in line with the UK government's current sanctions policy which emphasises cooperation with other countries.[59]

Cooperation of this nature could be achieved in the form of a stand-alone agreement or treaty, or it could be enshrined within an existing Regional Trade Agreement (RTA). The 12-party CPTPP is a good example of an RTA that could be modified to include such a commitment. The relevant provision in this treaty would specify that parties agree that requirements placed on sanctioned entities to re-invest assets into the sanctioning state will be construed to include re-investment into the territory of any parties to the RTA. The CPTPP's investment chapter includes a clause which prohibits parties from conditioning the receipt of an investment incentive on the implementation of various local content requirements.[60] This provision could be expanded to preclude the granting of an investment incentive, such as a tax break, to entities included on a sanctions list. Prohibited incentives could also include redistributing profits back to the sanctioned entity beyond some minimal threshold.

One plausible effect of multilateralising the compelled re-investment proposal would be that the investment would not enter the UK but rather one of the UK's allies, e.g. another party to the CPTPP. But given the transnational nature of supply chains and the increasing economic integration contemplated by comprehensive RTAs like CPTPP, economic benefits could indirectly accrue to the UK. Moreover, the potential to generate benefits in the form of increased foreign direct investment might compel party states to cooperate in the imposition of economic sanctions measures, increasing their effectiveness in terms of geopolitical pressure.

59 "Deter, Disrupt and Demonstrate – UK sanctions in a contested world" (Feb 2022) at 16

60 Art 9.10.2

VI - Conclusion

The UK's economic sanctions rules are broken. They have not yielded the geopolitical objectives for which they were designed, alienating the world community and the British public, especially those in business for whom secure international trade is essential. This paper has set out a potential solution based on leveraging positive incentives to invest sanctioned assets in the UK, rather than merely freezing them or turning them away.

The effectiveness of the proposed regime would turn on who the target of the sanctions regime is and what the UK government wants to achieve. If it is the actual investor who the UK government seeks to isolate, then granting that investor access to the UK market and giving it business opportunities is the farthest thing from what the sanctions regime is designed to achieve. On the other hand, if the actual target is another state or entity, the UK has attained its goal once divestment happens - the target has been further isolated (assuming a redirection of trading and capital flows does not happen). Forcing a company which has already suffered losses to bring the capital to the sanctioning jurisdiction and invest there is clearly beyond the goal of a conventional sanctions regime. But the goal of the UK is not to isolate the target, then compelling reinvestment into the UK achieves the added benefit of aiding the UK economy. The proposal, as conceived, addresses some of the key weaknesses of the UK's existing regime, including a lack of coordination with allies, and poor transparency. As it is predicated on positive incentives, it should also be easier to enforce without the need for strong penalties.

Legal and ethical issues could be raised by compelled re-investment sanctions. International law generally supports free trade and the rights of companies to invest where they choose. This strategy could provoke retaliation from the target country and other trading partners, potentially escalating into broader economic conflicts or trade wars. There is also a question of effectiveness. Companies may be more likely to seek alternative markets rather than comply with sanctions by investing in the sanctioning country. The global nature of modern business means there are often multiple viable markets and investment opportunities. It is also important to be aware of the reality that economic sanctions can create uncertainty and instability, making the sanctioning country less attractive for investment. Companies typically seek stable environments for their investments, and a country that uses sanctions aggressively might be perceived as risky.

As ever, the successful implementation of this policy would depend on the degree to which the UK government maintains transparency in terms of the entities subjected to economic sanctions and with regards to those which it has compelled to re-invest into the UK economy and into which sectors their funds have been channelled. The reasons for these decisions need to be made clear to the British public, in so far as national security permits. Ideally there would also be an element of public consultation / stakeholder engagement. The more public involvement in the decision regarding the sector / business of the compelled re-investment, the more likely there will be public buy-in and any moral dilemmas associated with investor gains will be minimised. To the extent that a sanctioned entity ultimately benefits from the scheme, this will be offset should broader social benefits accrue. It is not difficult to envisage stronger public support for this sanctions proposal were, for example, renewable energy or social housing be earmarked as sectors to which sanctioned funds would be diverted. In the event that sanctioned entities were enabled to continue their existing activity, adequate governmental messaging would be required to demonstrate the economic and social value of attracting the investment into the UK so as to avoid any backlash from consumers which could ensue.