15: Trade finance

Note: *This sectoral guidance is incomplete on its own. It must be read in conjunction with the main guidance set out in Part I of the Guidance Notes.*

Firms addressing the money laundering/terrorist financing risks in trade finance should also have regard to the guidance in sector 16: Correspondent banking.

Overview of the sector

15.1 'Trade Finance' is used to describe various operations, including the financing – usually but not exclusively by financial institutions - undertaken to facilitate trade or commerce, which generally involves the movement of goods and services between two points – it can therefore be domestic or international. The trade finance element may only be part of the overall financial component and may have multiple variations, e.g., a domestic trade finance transaction could support an international movement of goods, or on occasion only services may be involved (see paragraph 15.9: Funds transmission/payments). Such operations comprise a mix of money transmission instruments, default undertakings and provision of finance, which are described in more detail below. A glossary of trade finance terms used in this guidance is set out in Annex 15-I.

15.2 In the context of this guidance, the term 'Trade Finance' is used to refer to the financial component of an international trade transaction, i.e., managing the payment for goods and/or related services being imported or exported. Trade finance activities may include issuing letters of credit, standby letters of credit, bills for collection or guarantees. Trade Finance operations are often considered in a cross-border context but can also relate to domestic trade.

15.3 Past estimates suggest that approximately only a fifth of world trade is conducted by means of trade finance products and services; the rest is conducted on "Open Account" terms, whereby a 'clean' payment is made by the buyer of the goods or services direct to the seller, i.e., not requiring presentation of the supporting trade documentation to the banks through which the payment is effected. It follows that whenever credit and liquidity are scarce or trust between the transacting parties has not been established, sellers in particular will be inclined to revert to Trade Finance.

15.4 In Open Account transactions, unlike transactions where trade finance instruments are used, the bank is only aware of the payment and will not be aware of the reason for the payment, unless the relevant details are included in the associated SWIFT messages. Banks will therefore be able to carry out sanctions screening only on the payment, with anti money laundering checks achieved to the extent practicable by its risk-based transaction monitoring. Where credit is being provided, however, the bank may have more information to enable it to understand the reasons for the transaction and the financial movements. Banks are not required to investigate commercial transactions outside their knowledge, although if documentation they see as part of the banking transaction gives rise to suspicion, they should submit a SAR to SOCA, and seek consent, as appropriate.

15.5 The focus of this guidance is on those standard products used for the finance of the movement of goods or services across international boundaries. The products are:

- Documentary Letters of Credit (LCs) and
- Documentary Bills for Collection (BCs).

These standard products have trade related documents (invoices, transport documents etc) that are sent through financial institutions and are examined by documentary checkers within the financial institution for consistency with the terms of the trade transaction. Such operations are illustrated (in simple terms) in Annex 15-II, and are described in more detail below.

15.6 These products are governed internationally by sets of rules of practice issued by of the International Chamber of Commerce (ICC). The ICC rules governing BCs are fundamentally different from the ICC rules governing LCs. The checks, which have to be made within limited timeframes by the financial institution (Collecting or Presenting bank, see below), on BCs are limited to determining that the documents received appear to be as listed in the collection instruction.

15.7 International trade finance transactions will usually involve financial institutions in different locations, acting in a variety of capacities. For the purpose of LCs these may include an Issuing Bank, an Advising Bank, Nominated Bank, Confirming Bank or Reimbursing Bank. For BCs there will be a Remitting, Collecting or Presenting Bank. The nature of the capacity in which a financial institution may be involved is important, as this will dictate the nature and level of information available to the financial institution in relation to the underlying exporter/importer, the nature of trade arrangements and transactions. The fragmented nature of this process, in which a particular financial institution may of necessity have access only to limited information about a transaction, means that it may not be possible for any one financial institution to devise hard coded rules or scenarios, or any patterning techniques in order to implement a meaningful transaction monitoring system for the whole transaction chain.

15.8 The main types of trade finance operations are described in more detail below. Whilst they are addressed separately, they are not necessarily mutually exclusive and these operations may be combined in relation to a single transaction, series of transactions or, on occasion, in relation to a particular project. In terms of assessing risk, it is important to understand the detailed workings of individual operations/financial instruments, rather than automatically assuming that they fit into a particular category simply because of the name that they may have been given.

Funds Transmission/Payments

15.9 Trade finance operations often involve transmission of funds where the payment is subject to presentation of document(s) and/or compliance with specified condition(s). Financing may on occasion be provided either specifically related to the instrument itself, or as part of a general line of credit.

Default Undertakings

15.10 As the term implies, such undertakings normally only involve payment if some form of default has occurred. Typical undertakings in this category are bonds, guarantees, indemnities and standby letters of credit. Provision of finance is less common than with funds transmission/payment instruments, but could also occur.

15.11 Structured Financing

This category comprises a variety of financing techniques, but with the common aim of facilitating trade and commerce, where financing is the primary operation, with any associated Trade Finance instrument and/or undertaking being subsidiary. On occasion, such financing may be highly complex e.g., involving special purpose vehicles (SPVs). Finance may be provided against evidence of performance under a trade contract, often on a staged basis that represents progress in that contract.

What are the financial crime risks in Trade Finance?

General

15.12 A key risk around trade finance business is that seemingly legitimate transactions and associated documents can be constructed simply to justify the movement of funds between parties, or to show a paper trail for non-existent or fraudulent goods. In particular, the level and type of documentation received by a firm is dictated principally by the applicant or instructing party, and, because of the diversity of documentation, firms may not be expert in many types of the documents received as a result of trade finance business (although experienced trade finance staff should have a good understanding of the most commonly used types of document). Such a risk is probably greatest where the parties to an underlying commercial trade transaction are in league to disguise the true nature of a transaction. In such instances, methods used by criminals to transfer funds illegally range from over and under invoicing, to the presentation of false documents or spurious calls under default instruments. In more complex situations, for example where asset securitisation is used, trade receivables can be generated from fictitious parties or fabricated transactions (albeit the use of asset securitisation in trade finance is a very limited activity). The use of copy documents, particularly documents of title, should be discouraged, and should raise a due diligence query, except where the location of the original documents (of title) and the reasons for their absence is disclosed to and acceptable by the banks in the transaction.

15.13 A form of trade finance is generally used instead of clean payments and generic lending to provide additional protection for the commercial parties and independent and impartial comfort when parties require some level of performance and payment security or when documentation is required for other purposes e.g., to comply with Customs, other regulatory requirements, control of goods and/or possible financial institution requirements. The key money laundering/terrorism risks arise when such documentation is adapted to facilitate non-genuine transactions, normally involving movement of funds at some point.

15.14 The Financial Action Task Force (FATF), regulators and others have identified misuse of the trade system as one of the methods by which criminal organisations and terrorist financiers move money for the purpose of disguising its origins and integrating it into the legitimate economy. FATF typologies' studies indicate that criminal organisations and terrorist groups exploit vulnerabilities in the international trade system to move value for illegal purposes. Cases identified included: illicit trafficking in narcotic drugs; illicit trafficking in stolen or other goods; corruption and bribery; fraud; counterfeiting/piracy of products; and smuggling. More complicated schemes integrate these fraudulent practices into a complex web of transactions and movements of goods and money.

Money laundering risk

15.15 Given the nature of the business, there is little likelihood that trade finance will be used by money launderers in the placement stage of money laundering. However, trade finance can be used in the layering and integration stages of money laundering as the enormous volume of trade flows obscure individual transactions and the complexities associated with the use of multiple foreign exchange transactions and diverse trade financing arrangements permit the commingling of legitimate and illicit funds.

15.16 FATF's June 2006 study of Trade Based Money Laundering[18] defined trade-based money laundering as "the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illicit origins. In practice, this can be achieved through the misrepresentation of the price, quantity or quality of imports or exports.

[18] http://www.fatf-gafi.org/dataoecd/60/25/37038272.pdf

Moreover, trade-based money laundering techniques vary in complexity and are frequently used in combination with other money laundering techniques to further obscure the money trail". The study concludes that "trade-based money laundering represents an important channel of criminal activity and, given the growth in world trade, an increasingly important money laundering and terrorist financing vulnerability. Moreover, as the standards applied to other money laundering techniques become increasingly effective, the use of trade-based money laundering can be expected to become increasingly attractive". The term 'trade transactions' as used by the FATF is wider than the trade transactions described in this sectoral guidance.

15.17 FATF's June 2006 study notes that the basic techniques of trade-based money laundering include:

- **Over Invoicing:** by misrepresenting the price of the goods in the invoice and other documentation (stating it at above the true value) the seller gains excess value as a result of the payment[19].
- **Under invoicing:** by misrepresenting the price of the goods in the invoice and other documentation (stating it at below the true value) the buyer gains excess value when the payment is made.
- **Multiple invoicing:** by issuing more than one invoice for the same goods a seller can justify the receipt of multiple payments. This will be harder to detect if the colluding parties use more than one financial institution to facilitate the payments/transactions.
- **Short shipping:** the seller ships less than the invoiced quantity or quality of goods thereby misrepresenting the true value of goods in the documents. The effect is similar to over invoicing
- **Over shipping:** the seller ships more than the invoiced quantity or quality of goods thereby misrepresenting the true value of goods in the documents. The effect is similar to under invoicing.
- **Deliberate obfuscation of the type of goods:** parties may structure a transaction in a way to avoid alerting any suspicion to financial institutions or to other third parties which become involved. This may simply involve omitting information from the relevant documentation or deliberately disguising or falsifying it. This activity may or may not involve a degree of collusion between the parties involved and may be for a variety of reasons or purposes.
- **Phantom Shipping:** no goods are shipped and all documentation is completely falsified.

15.18 Generally, these techniques involve fraud by one party against another, but may also depend upon collusion between the seller and buyer, since the intended outcome of the trade is to obtain value in excess of what would be expected from an arms' length transaction, or to move funds from point A to point B without being detected or accounted for by the authorities. The collusion may arise, for example, because the parties are controlled by the same persons, or because the parties are attempting to evade taxes on some part of the transaction.

15.19 Some countries require that for the importation of certain types of goods, independent inspection agents certify that the goods meet the specified quality standards and that the prices charged are appropriate. The buyer and seller may also agree to use inspection agents, who will issue a certificate confirming the quality and/or price. Trade Finance staff should understand the circumstances where inspection certificates are required.

Sanctions/proliferation financing

[19] A report by Global Financial Integrity showed there was an estimated average of $725billion to $810 billion per annum in illicit financial flows from Developing Countries between 2000 and 2009. Of these amounts, 55% was due to trade mispricing. See http://iff-update.gfip.org/

15.20 There is at present no agreed definition of proliferation or proliferation financing. FATF's Working Group on Terrorist Financing and Money Laundering has proposed the following definition of proliferation financing for the purposes of its work:

> *[Proliferation financing is] the act of providing funds or financial services which are used, in whole or in part, for the manufacture, acquisition, possession, development, export, trans-shipment, brokering, transport, transfer, stockpiling or use of nuclear, chemical or biological weapons and their means of delivery and related materials (including both technologies and dual-use goods used for non-legitimate purposes), in contravention of national laws or, where applicable, international obligations*[20].
>
> ***[Combating Proliferation Financing:* A Status Report on Policy Development and Consultation - *February 2010*[21]*]***

15.21 Dual-use goods are items that have both commercial and military or proliferation applications. This can include goods that are components of a weapon, or those that would be used in the manufacture of a weapon (*e.g.,* certain machine tools that are used for repairing automobiles can also be used to manufacture certain component parts of missiles).

15.22 Dual-use goods destined for proliferation use are difficult to identify, even when detailed information on a particular good is available. Regardless of the amount of information provided for a particular good, highly specialised knowledge and experience is often needed to determine if a good may be used for proliferation. Dual-use items can be described in common terms with many uses – such as "pumps" – or in very specific terms with more specific proliferation uses – such as metals with certain characteristics. Further, many goods are only regarded as dual-use if they measure-up to very precise performance specifications.

15.23 Proliferation differs from money laundering in several respects. The fact that proliferators may derive funds from both criminal activity and/or legitimately sourced funds means that transactions related to proliferation financing may not exhibit the same characteristics as conventional money laundering. Furthermore, the number of customers or transactions related to proliferation activities is likely to be markedly smaller than those involved in other types of criminal activity such as money-laundering.

15.24 There are a variety of United Nations (UN) and national and regional sanctions in place. These include:

- Country-based financial sanctions that target specific individuals and entities
- Trade-based sanctions, e.g., embargos on the provision of certain goods, services or expertise to certain countries

In recent years there has also been a series of UN Security Council Resolutions which have, inter alia, introduced targeted financial sanctions and/or activity-based financial prohibitions in respect of certain countries which relate to the prevention of WMD proliferation.

15.25 Compliance with the sanctions in force within jurisdictions is relevant to all the products and services offered by firms. Sanctions that require the embargo of certain goods and services have particular relevance in relation to the provision and facilitation of trade finance products.

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[20] The definition of an *act* of proliferation financing need not involve knowledge. However, when considering the responsibilities of financial institutions or a possible criminal basis of proliferation financing, a subjective element will be indispensable.

[21] http://www.fatf-gafi.org/dataoecd/32/40/45049911.pdf

15.26 A summary of the legal and regulatory obligations in relation to proliferation financing is set out in Annex 15-III. Guidance on sanctions screening is given in Part III, section 4: *Compliance with the UK financial sanctions regime.*

15.27 The use of trade finance to breach sanctions and/or for the proliferation of weapons of mass destruction (WMD) could potentially take advantage of the complex and fragmented nature of existing global finance activity where multiple parties (in many cases with limited knowledge of one another) become involved in the handling of trade finance.

15.28 In June 2008, FATF published a Proliferation Financing Report[22] which assessed these risks. Annex 15-IV reproduces that report's discussion of how various types of entity in the financial sector might become involved in proliferation activities.

15.29 In April 2010 the FATF published a February 2010 report from their Working Group on Terrorist Financing and Money Laundering '*Combating Proliferation Financing: A Status Report on Policy Development and Consultation*'[23] which further analysed the risks and possible policy responses.

Assessing the trade-based financial crime risk

15.30 A firm's risk-based approach should be designed to ensure that it places an emphasis on deterring, detecting and disclosing in the areas of greatest perceived vulnerability, in order to counter to the extent practicable the above trade-based money laundering, terrorist financing and proliferation financing techniques.

Money laundering/terrorist financing

15.31 The ability of a firm to assess the money laundering/terrorist financing risks posed by a particular transaction will depend on the amount of information that it has about that transaction and the parties to it. This will be determined by the firm's role in the Trade Finance operation. The amount of information available to a firm may vary depending on the size/type of the firm and the volume of business that it is handling. Where possible when assessing risk, firms may take into consideration the parties involved in the transaction and the countries where they are based, as well as the nature of any goods forming the basis of an underlying commercial transaction.

15.32 Apart from direct information, firms should have regard to public sources of information that are available at no or minimal direct cost, such as those available on the internet. For example, firms may validate bills of lading by reference to the websites of shipping lines, most of whom offer a free facility to track movements of containers. By using the unique container reference number, firms may be able to confirm that the container was loaded on a designated vessel and that vessel is undertaking the claimed voyage. The websites of many shipping lines provide details of the current and future voyages being undertaken by their ships and up to date information regarding their precise location. For example, see the website http://www.marinetraffic.com/ais/default.aspx?centerx=30&centery=25&zoom=2&level1=140. Firms would not be expected to investigate commercial transactions outside their knowledge, although naturally if documentation they see as part of the banking transaction gives rise to suspicion, this should be reported.

15.33 When developing a risk-based strategy firms should consider, but not restrict their consideration to, factors such as the size of the transaction, nature of the transaction, geographical location of the parties and the customer's business mix.

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[22] http://www.fatf-gafi.org/dataoecd/14/21/41146580.pdf

[23] http://www.fatf-gafi.org/dataoecd/32/40/45049911.pdf

15.34 Firms need to be aware of trade-based money laundering techniques when developing their risk-based strategy and consider how best to mitigate the risks to themselves. The FATF has listed some red flag indicators in its June 2006 report, which are reproduced in Annex 15-V.

15.35 In certain specific, highly structured transactions firms should exercise reasonable judgement and consider whether additional investigation should be undertaken. Such investigation may include determining whether over-invoicing or under-invoicing, or any other misrepresentation of value, may be involved, which cannot usually be based solely on the trade documentation itself. Nor can the use of external data bases alone be relied upon as most products are not traded in public markets and have no publicly available prices. Even where such prices are available, such as those for commodities, firms will not be aware of the terms of trade, discounts involved or quality of the goods etc, so making a determination of the unit pricing will always be difficult. However, where the unit price of goods is materially different from the current market value, firms should consider whether they have a suspicion and whether they should accordingly submit an SAR to SOCA.

Proliferation financing

15.36 Particular issues arise in relation to possible proliferation financing risks presented by customers and products, and these are discussed in Annex 15-VI.

General

15.37 It is recommended that firms create a risk policy (including the risk of financial crime abuse) and controls appropriate to their business which they may be required to justify to their regulators.

15.38 Whilst it is recognised that firms will not be familiar with all types of documentation they see, they should pay particular attention to transactions which their own analysis and risk policy have identified as high risk and be on enquiry for anything unusual.

15.39 In addition to this Guidance, firms may also find some useful information in the private sector Wolfsberg Group guidance - Trade Finance Principles 2008 (January 2009) - (see www.wolfsberg-principles.com/standards and then go to Wolfsberg Standards – Wolfsberg AML Principles).

Customer due diligence

General

15.40 With the partial exception of Collections (see below), the required due diligence must be undertaken on the customer who is the instructing party for the purpose of the transaction (see below). Due diligence on other parties to the transaction, including other customers, should be undertaken where required by a firm's risk policy. Reference to Part I, Chapter 5 should be made as appropriate. Additional due diligence on other parties, and possibly on the transaction itself, should be undertaken where required by the firm's internal risk policy and where the firm is specifically on enquiry.

15.41 It should be noted that the instructing party will normally be an existing customer of the firm but, if not, due diligence must be undertaken on the instructing party before proceeding with the transaction (see Part I, Chapter 5).

15.42 The following list of instructing parties is not exhaustive and where necessary firms will need to decide in each case who the instructing party is (these enquiries are in addition to the standard due diligence undertaken by the firm as a condition of its account relationship):

- Import (Outward) Letters of Credit - the instructing party for the issuing bank is the **applicant**. Questions from the issuing bank that should arise during the initial due diligence process where LC facilities are required would be such as to establish from the applicant:

  - The countries in relation to which the applicant trades, and the trading routes utilised
  - The goods traded
  - The type and nature of parties with whom the applicant does business (e.g., customers, suppliers, etc)
  - The role and location of agents and other third parties used by the applicant in relation to the business (where this information is provided by the applicant).

- Export (Inward) Letters of Credit - the instructing party for the advising/confirming bank is the **issuing bank**.

  - The advising/confirming bank should undertake appropriate due diligence on the issuing bank (as set out in Part II, sector 16: Correspondent banking). The due diligence may support an ongoing relationship with the issuing bank which will be subject to a relevant risk based review cycle. Due diligence on the issuing bank is not therefore required in relation to each subsequent transaction.

  - In other circumstances, the advising bank may not have an ongoing relationship with the issuing bank and may simply act to process the transaction, in which case due diligence may be conducted on a different basis. As a minimum the advising bank will need to ensure that there is a means of authenticating any LC received from the issuing bank.

  - Although there is no requirement to carry out customer due diligence on the LC beneficiary, firms may decide to carry out some checks e.g., check existence at Companies House (or equivalent foreign registry), with on-line trade directories, professional advisers or availability of financial statements – subject to their own risk based approach – to confirm the validity of the transaction if the LC is issued by a bank in a country that is considered high risk and if the nature of the transaction (goods, shipment from/to, payment terms etc) warrants further investigation. Financial statements are a useful source of information, as they usually provide a description of the company's main activities, as well as giving information about the size of its financial operations.

- Outward Collections - the instructing party is the **customer/applicant**.

  - Firms should carry out due diligence on the instructing party (exporter) who in many cases will be their customer, on whom they have already carried out due diligence.

- Inward Collections - due diligence should be carried out on the drawee, who will normally be the importer or party acting on behalf of the importer. In most cases the drawee will be an existing customer of the bank receiving the collection, on whom standard due diligence for AML purposes will already have been carried out. Depending on the nature of the transaction and whether it is consistent with the known trading activity of the customer and normal scale thereof, further enquiry may be prudent on a case by case basis.

- Bonds/Guarantees - the instructing party may be either a customer, correspondent bank or other third party.

Sanctions/proliferation financing – CDD and screening

15.43 The ability of firms to implement *activity-based controls* against proliferation is limited, due to the lack of technical expertise of firms, the limited information available as a basis for such controls and firms' inability to examine whether such information is correct; the structural differences between money laundering and proliferation financing and the lack of clear financial patterns uniquely associated with proliferation financing; and the fragmented nature of the trade cycle, which limits each firm's visibility of the whole transaction.

15.44 *Targeted financial sanctions*[24] provide firms with proliferation-related information on which they can take action. Targeted financial sanctions are considered to be most effective when they are implemented globally *i.e.* by the UN, since a designated entity cannot as easily turn to third-country firms to evade sanctions.

15.45 Some jurisdictions have established their own capability to impose targeted financial sanctions on individuals and entities they deem involved in WMD proliferation, independent of sanctions agreed by the UN Security Council. The European Union (EU) has also adopted such sanctions based on specific legislation relating to certain countries of specific proliferation concern.

15.46 Targeted financial sanctions may also prompt a proliferation-related entity to conceal its involvement in a transaction. This may involve the use of unusual financial mechanisms which may arouse suspicion among legitimate exporters, or patterns of activity which may generate suspicion of money laundering.

15.47 Where lists of entities are available, firms should consider whether undertaking real-time screening of transactions is appropriate. Lists of entities in this context could potentially include both entities subject to targeted financial sanctions e.g., UNSCR 1737, under which transactions with named entities are prohibited; as well as (if such lists are made available), entities of proliferation concern, which have been identified as high-risk by competent authorities and which could be subject to enhanced due diligence and/or suspicious activity reporting. Firms should be careful not unintentionally to treat all types of lists as financial sanctions lists, thus running the risk of prohibiting business with these entities and jurisdictions altogether. Real-time screening against listed entity-names has limitations, however, and may be evaded if the listed entity changes its name or operates through a non-listed front company.

15.48 Alternative approaches would be required to identify and prevent proliferation financing activity conducted by non-listed entities. These could include both manual systems – enhanced due diligence, increased monitoring, and enhanced frequency of relationship reviews – and automatic systems such as post-event monitoring of account activity.

15.49 Post event monitoring, using multiple risk indicators, may in any event have the potential to identify proliferation financing activity.

15.50 *Goods based screening*; evaluation of the goods involved in a transaction very often requires a large amount of technical knowledge only available to export controls experts and/or exporters. Goods lists pose a tremendous challenge even for export control enforcement and certainly a greater one for real time screening than entity lists. Furthermore, firms in general lack the expertise to discriminate between legitimate and proliferation-sensitive goods. Goods lists, in themselves, should not be used as a basis for transaction screening, as their limited effectiveness, and greater difficulty, make them an inefficient safeguard.

Forfaiting

15.51 The diverse nature of forfaiting business is such that the exact nature of the transaction needs to be

[24] For the purposes of this guidance, "targeted financial sanctions" includes not only asset freezing, but also prohibitions to prevent funds from being made available to "designated" or "listed" persons and entities.

considered. For example, the need to ensure authenticity may lead to enquiries being made of the importer's management, and it may be necessary to examine the commercial parts of documents, dependent on the nature of the underlying commercial transaction.

15.52 In the primary Forfaiting, or origination, market, a firm will usually be dealing directly with an exporter, who will be its customer and on whom it should carry out due diligence in accordance with Part I, Chapter 5. In addition, as part of its risk-based approach, a firm, where appropriate, should scrutinise the other party to the underlying commercial transaction, as well as the transaction itself, to satisfy itself of the validity of the transaction. The amount and depth of scrutiny will depend on the firm's risk assessment of the client and transaction.

15.53 In the secondary Forfaiting market, the firm's customer will be the person from whom it buys the evidence of debt. However if it holds a Forfait asset to maturity it will be receiving funds from the guarantor bank and thus it should as a matter of course perform due diligence on this entity as well. Using a risk-based approach, firms should also consider whether they should conduct some form of due diligence on the underlying parties to the transaction, as well as on the transaction itself. This will depend on a risk assessment of the countries and the types of clients or products and services involved. It may be necessary to examine documentation on the underlying commercial transaction. However, it should be borne in mind that the further away from the original transaction the purchaser of a Forfait asset is, the harder it will be to undertake meaningful due diligence.

Structured Financing

15.54 As stated above, structured finance transactions are diverse in nature. Due diligence should be undertaken on all relevant parties in accordance with the firm's own risk policy/assessment.

Enhanced due diligence

15.55 Where the nature of a transaction displays higher risk characteristics than normal business undertaken for the customer (instructing party), for example, the buyer falls into a higher risk category then the firm should consider undertaking additional due diligence in line with its risk policies. Some of the checks firms could undertake (not all of which may be applicable or available in each case) include:

- make enquiries as appropriate into the ownership and background of the other parties to the transaction e.g., the beneficiary(ies), agents, shipping lines, taking further steps to verify information or the identity of key individuals as the case demands;
- seek information from the instructing party about the frequency of trade and the quality of the business relationships existing between the parties to the transaction. This should be documented to assist future due diligence;
- check the transaction against warning notices from external public sources, for example the ICC's International Maritime Bureau;
- refer the transaction to external agencies specialising in search and validation services in respect of bills of lading, shipping services and commodity prices, for example the ICC Commercial Crime Services;
- check details of the source of goods;
- check public source information for prices of goods such as commodities – where the contract price is significantly different from the market [say 25%] then consider further investigation;
- attend and record relationship meetings with the instructing party, visit them by arrangement;
- for export letters of credit, refer details to other Group resources on the ground in the country of origin, to seek corroboration.
- checks into the verification of shipments after the UCP operation is over, drawn at random from a sample of transactions, across a cross section of the bank’s trade finance clients. This

may help to identify spurious transactions where buyers and sellers act in collusion.

15.56 The enhanced due diligence should be designed to understand the nature of the transaction, the related trade cycle for the goods involved, the appropriateness of the transaction structure, the legitimacy of the payment flows and what control mechanisms exist.

15.57 The nature of business and the anticipated transactions as described and disclosed in the initial due diligence stage may not necessarily suggest a higher risk category but if, during the course of any transaction any high risk factors become apparent, this may warrant additional due diligence. For example – although these may in some cases be used legitimately - where third party middlemen or traders use back to back or transferable LCs to conclude offshore deals, or where the buyer is itself a middleman or trader.

Monitoring

15.58 Firms should have regard to the general guidance set out in Part I, section 5.7 on monitoring and in Chapter 6, on reporting suspicious transactions, and requesting consent where appropriate. The depth and frequency of monitoring to be undertaken will be determined by a firm's risk analysis of the business and/or the parties involved. Firms should, however, implement such controls and procedures appropriate to their business, but in any event must comply with any applicable legal or regulatory requirements.

15.59 Firms may refer to sources of information that may be relevant to assessing the risk that particular goods may be 'dual-use', or otherwise subject to restrictions on their movement. For example, there are public resources (such as the EC's TARIC database) that can indicate which restrictions might apply to exports from the EU with specific tariff codes: it will show where trade in some types of good under that category might be licensable or prohibited. Exporters must already provide tariff codes to the customs authorities (who use them to calculate the tax levied on the trade), so should be able to provide them to their banks, insurers and their agents. These can be used to identify transactions that might present higher risk or require further due diligence checks, particularly in situations where the risks are perceived to be higher). For example, have issuing banks, applicants or beneficiaries of letters of credit, or freight companies and shipping lines moving the goods, been highlighted by national authorities as being of concern? (This information will often be recorded on commercially-available due diligence tools). Does the trade involve jurisdictions previously implicated in proliferation activity?

15.60 Techniques dependent on a firm's risk analysis/policy could range from random, after the event, monitoring to checking receivables in any form of securitisation transaction to seek to determine if they are legitimate.

15.61 In the automatic monitoring of transactions the drivers that flag 'unusual transactions' tend to be built around:

- payment values
- volume of payments
- countries of payment
- originator/beneficiary names
- patterns in relation to a country or entity name
- volume of shipments (e.g., tonnes)

However, the exact configuration of monitoring systems will differ between firms.

15.62 Alerts generated from these automatic systems are usually subject to some type of human intervention. Therefore, the effective application of a risk-based approach to monitoring is only

possible if based on intelligence-based risk indicators, such as geographical combinations or geographical patterns of high-risk payment flows.

15.63 Depending on the screening tool that it employs, a bank may be able to screen SWIFT messages for indications of prohibited or licensed goods, such as armaments.

15.64 The ability of a firm to detect suspicious activity will often be constrained. For instance, in the case of fragmented trade finance arrangements the availability of information will be a particularly limiting factor in enabling firm to understand who the ultimate buyer (or seller) of a product is, or what the ultimate end use of product may be. Whilst all firms are expected to have a form of financial transaction monitoring in place, the information presented to a firm will clearly vary according to its role in a particular transaction and the type of payment system used. For instance in the case of letters of credit, the firm will have some – albeit often limited - information on the underlying transaction if it is the issuing bank and less information if it is the advising bank. The extent to which available information will need to be verified will also vary depending on this role.

Staff awareness, training and alertness

15.65 The firm must train staff on how trade finance transactions may be used for ML/TF and in the firm's procedures for managing this risk. This training should be directed specifically at those staff directly involved in trade finance transactions, including those in relevant back office functions, and should be tailored around the specific risks that this type of business represents.

15.66 Trade Finance staff need to have a high level understanding of export licence regimes and of the importance of seeking evidence from relevant parties to the transaction that an export licence has been obtained for appropriate transactions.

15.67 The FATF's red flag indicators set out in Annex 15-V, although directed primarily at governmental agencies, nevertheless should be a useful aid to those devising firms' training programmes. In addition the several case studies set out in the study may also provide good training material. This study is available at www.fatf-gafi.org/dataoecd/60/25/37038272.pdf.

ANNEX 15-I

Glossary of trade finance terms used in this guidance

Bills of Exchange. A signed written unconditional order by which one party (drawer or trade creditor) requires another party (drawee or trade debtor) to pay a specified sum to the drawer or a third party (payee or trade creditor) or order, on demand or at a fixed or determinable future time. In the UK, the relevant legislation is the Bills of Exchange Act 1882, as amended. In cross-border transactions, equivalent laws may also apply. In many other European jurisdictions, transactions will be subject to the Geneva Conventions on Bills of Exchange 1932. Bills of Exchange can be payable at sight or at a future date, and if either accepted and/or avalised, represent a commitment by the accepting or Avalising party to pay funds, thus making them the primary obligor.

Acceptances/Deferred Payment Undertakings. Where the drawee of a bill of exchange signs the bill with or without the word "accepted" on it, the drawee becomes the acceptor and is responsible for payment on maturity. Where banks become the acceptor these are known as "bankers' acceptances" and are sometimes used to effect payment for merchandise sold in import-export transactions. Avalisation that occurs in forfaiting and some other transactions is similar to acceptance but does not have legal standing under English law. Banks may also agree to pay documents presented under a documentary credit payable at a future date that does not include a bill of exchange. In such instances the bank incurs a deferred payment undertaking.

Promissory Notes. These are a written promise committing the issuer to pay the payee or to order, (often a trade creditor) a specified sum either on demand or on a specified date in the future. (This is similar to a bill of exchange).

Guarantees and Indemnities. Sometimes called Bonds, these are issued when a contractual agreement between a buyer and a seller requires some form of financial security in the event that the seller fails to perform under the contract terms, and are normally issued against a backing "Counter Indemnity" in favour of the issuing firm. There are many variations, but a common theme is that these are default instruments which are only triggered in the event of failure to perform under the underlying commercial contract.

Documentary Credits. Historically, these were one of the most commonly used instruments in Trade Finance transactions and although their usage has declined in recent years, particularly in intra-Western European trade, unfavourable credit conditions could reverse this trend, especially in developing markets (at least in the short term). They remain in extensive use in trade involving deep sea transport and in certain geographical areas e.g., South East Asia. In its simplest form a Documentary Credit is normally issued by a bank on behalf of a purchaser of merchandise or a recipient of services (a trade debtor), in favour of a beneficiary, usually the seller of the merchandise or provider of services (a trade creditor). The issuer (usually a bank) irrevocably promises to pay the seller/provider at sight, or at a future date if presented with documents which comply with the terms and conditions of the Documentary Credit. Effectively, the Documentary Credit substitutes the Issuing Bank's credit for that of the applicant subject to the terms and conditions being complied with. When a Documentary Credit is confirmed by another bank, the Confirming Bank adds its own undertaking as principal to that of the Issuing Bank i.e. the Confirming Bank becomes a primary obligor in its own right. There are many more complex variations than this simple example, but almost all Documentary Credits worldwide are issued and handled subject to the applicable International Chamber of Commerce (ICC) Uniform Customs & Practice for Documentary Credits in force (currently UCP 600).

Collections. A typical documentary collection involves documents forwarded by an exporter's bank to an importer's bank to be released in accordance with the accompanying instructions. These instructions could require release of documents against payment or acceptance of a bill of

exchange. As with Documentary Credits, there are a number of possible variations and the term collection is also used in other contexts. However, Collections of the type described above are normally but not always handled subject to the applicable ICC Uniform Rules for Collections - URC in force (currently ICC Publication 522).

Standby Letters of Credit. Unlike Documentary Credits, Standby Letters of Credit are default instruments which are sometimes issued instead of a guarantee. They may be issued subject to the applicable ICC rules in force, currently either UCP 600 or International Standby Practices (ISP 98), but may also contain specific exemption wording.

Discounting. A bank may discount a bill of exchange or a deferred payment undertaking, paying less than the face value of the bill/documents to the payee or trade creditor for the privilege of receiving the funds prior to the specified date. The trade debtor may not be informed of the sale and the trade creditor may continue to be responsible for collecting the debt on behalf of the discounter.

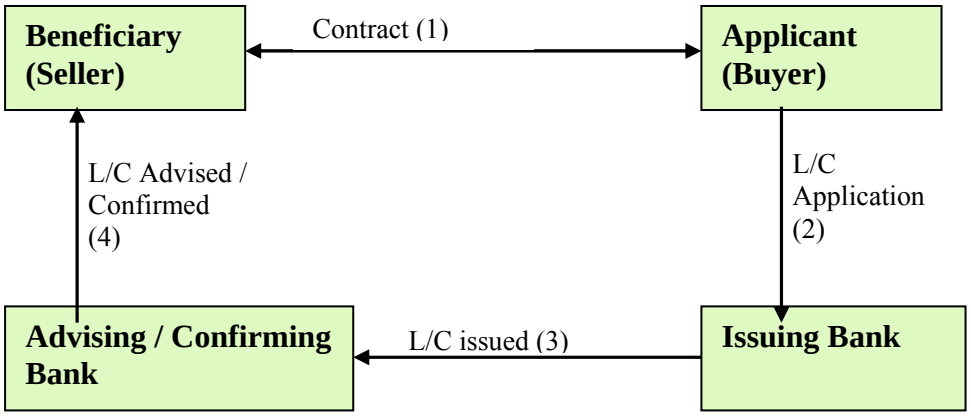
Negotiation. This term has a variety of meanings dependent on the jurisdiction/territory in which it is being used but for the purposes of UCP 600 means "the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank".

Forfaiting. This is a financing mechanism traditionally designed for use by trade creditors who export goods. Forfaiting, however, may also involve the direct provision of finance to importers and the provision of working capital by credit institutions for the purposes of funding trade transactions in their countries. The trade creditor or exporter sells evidence of a debt, usually a promissory note issued by the importer or a bill of exchange accepted by the importer or proceeds due under a Letter of Credit such proceeds being assigned by the exporter. The sale is normally made without recourse to the trade creditor/exporter in which case the person buying the debt will usually require the importer's payment obligations to be guaranteed by a bank (avalised).

ANNEX 15-II

The Process for a Confirmed Documentary Credit payable at sight at the counters of the nominated bank

Stage 1



Basic Documentary Credit Procedure

The documentary credit procedure involves the step-by-step exchange of documents required by the credit[19] for either cash or a contracted promise to pay at a later time. There are four basic groupings of steps in the procedure: (a) Issuance; (b) Amendment, if any; (c) Utilisation; and (d) Settlement. A simplified example follows:

(a) Issuance

Issuance describes the process of the buyer's applying for and the issuing bank opening a documentary credit and the issuing bank's formal notification of the seller either directly or through an advising bank.

(1) Contract – The Buyer and Seller agree on the terms of sale: (a) specifying a documentary credit as the means of payment, (b) naming an advising bank (usually the Seller's bank), and (c) listing required documents. The naming of an Advising Bank may be done by the buyer or may be chosen by the issuing bank based on its correspondent network.

(2) Issue Credit – The Buyer applies to his bank (Issuing Bank) and the issuing bank opens a documentary credit naming the Seller as beneficiary based on specific terms and conditions that are listed in the credit.

(3) Documentary Credit – The Issuing Bank sends the documentary credit either directly or through an advising bank named in the credit. An advising bank may act as a bank nominated to pay or negotiate (nominated bank) under the credit or act as a confirming bank where it adds its undertaking to the credit in addition to that of the issuing bank. Only in those cases where an advising bank is not nominated to negotiate or confirm the credit is the role of that bank simply an advising bank.

(4) Credit Advice - The advising, nominating or confirming bank informs (advises) the seller of the documentary credit.

(b) Amendment

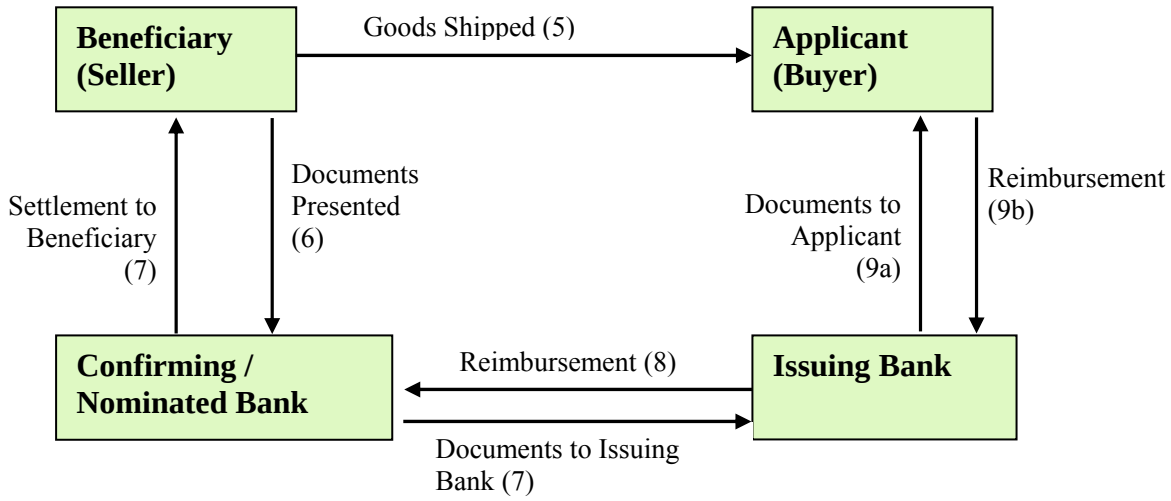
Amendment describes the process whereby the terms and conditions of a documentary credit may be modified after the credit has been issued.

When the seller receives the documentary credit, it may disagree with the terms and conditions (*e.g.* the transaction price listed in the credit may be lower than the originally agreed upon price) or may be unable to meet specific requirements of the credit (*e.g.* the time may be too short to effect shipment).

If the seller wants to amend the terms prior to transacting, the seller can request these from the buyer. It is at the discretion of the buyer to adopt the proposed amendments and request an amendment to be issued by the issuing bank. An amended letter of credit would be issued by the issuing bank to the seller through the same channel as the original documentary letter of credit.

Amendments to a letter of credit require the agreement of the issuing bank, confirming bank (if any), and the beneficiary to become effective.

Stage 2



(c) Utilisation

Utilisation describes the procedure for the seller's shipping of the goods, the transfer of documents from the seller to the buyer through the banks (presentation), and the transfer of the payment from the buyer to the seller through the banks (settlement). For example:

(5) Seller ships goods – The seller (beneficiary) ships the goods to the buyer and obtains the documents required by the letter of credit.

(6) Seller presents documents to Advising or Confirming Bank or directly to the Issuing Bank – The seller prepares and presents a document package to his bank (the advising or confirming bank) consisting of (a) the transport document if required by the credit, and (b) other documents (*e.g.* commercial invoice, insurance document, certificate of origin, inspection certificate, etc.) as required by the documentary credit.

(7) Nominated or Confirming Bank reviews documents and pays Seller - The nominating or confirming bank (a) reviews the documents making certain the documents are in conformity with the terms of the credit and (b) pays the seller (based upon the terms of the credit) which may mean that payment does not occur until after (5). An advising bank does not normally examine the documents, but simply forwards them on to the confirming or issuing bank for their examination.

(8) Advising, Nominated or Confirming Bank transfers documents to Issuing Bank – The Advising, Nominated or Confirming bank sends the documentation by mail or courier to the issuing bank.

(9) Issuing Bank reviews documents and reimburses the Nominated or Confirming Bank or makes payment to the beneficiary through the Advising Bank – The Issuing Bank (a) reviews the documents making certain the documents are in conformity with the terms of the credit, under advice to the Buyer that the documents have arrived, and (b) pays the beneficiary through the advising bank or reimburses the nominated or confirming bank (based upon the terms of the credit) and,

(10) Buyer reimburses the Issuing Bank – The Buyer immediately reimburses the amount paid by the issuing bank or is granted a credit by the issuing bank allowing it to reimburse the issuing bank at a later date.

(11) Buyer receives documents and access to goods – The Issuing Bank sends the documents by mail or courier to the buyer who then takes possession of the shipment.

(d) Settlement

The form of payment is specified in the original credit, and must therefore be accepted by the seller. The following are common settlement methods:

- The Sight Credit (Settlement by Payment) – In a sight credit, the value of the credit is available to the exporter as soon as the terms and conditions of the credit have been met (as soon as the prescribed document package has been presented to and checked by the issuing, nominated or confirming bank and found to be conforming to the terms and conditions of the credit) or once the advising bank has received the funds from the issuing bank (unconfirmed). Payment may be affected (sic) directly by the nominated bank or confirming bank upon their examination of the documents and they are reimbursed for that payment by the issuing bank.

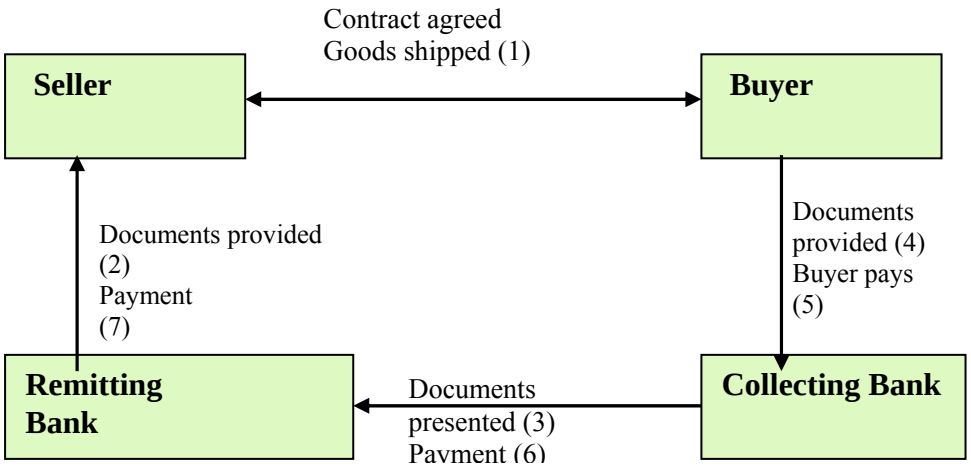
- The Usance Credit (Settlement by Acceptance) – In a Usance Credit, the beneficiary presents the required document package to the bank along with a time draft drawn on the issuing, nominated or confirming bank, or a third bank for the value of the credit. Once the documents have been found to be in order, the draft is accepted by the bank upon which it is drawn (the draft is now called an acceptance) and it may be returned to the seller who holds it until maturity.

- The Deferred Payment Credit - In a deferred payment credit the issuing bank and/or the nominated or confirming bank accepts the documents and pays the beneficiary after a set period of time. The issuing, nominated or confirming bank makes the payment at the specified time, when the terms and conditions of the credit have been met.

- Negotiation is the term used where a bank other than the issuing bank agrees to advance funds or discount drafts to the exporter before the issuing bank has paid. Discounting an accepted draft has the same effect.

A letter of credit will normally require the presentation of several documents including a Draft, Commercial Invoice, Transport Document, Insurance Document, Certificates of Origin and Inspection, Packing and Weight Lists.

The Documentary Collection Process



The documentary collection procedure involves the step-by-step exchange of documents giving title to goods for either cash or a contracted promise to pay at a later time.

Contract for the purchase and sale of goods – The Buyer and Seller agree on the terms of sale of goods: (a) specifying a documentary collection as the means of payment, (b) naming a Collecting Bank (usually the buyer's bank), and (c) listing required documents.

(1) Seller ships the goods – The Seller ships the goods to the Buyer and obtains a transport document from the shipping firm/agent. Various types of transport documents (which may or may not be negotiable) are used in international trade and only where required by the underlying transaction is a negotiable document used.

(2) Seller presents documents to Remitting Bank – The Seller prepares and presents a document package to his bank (the Remitting Bank) consisting of: (a) a collection order specifying the terms and conditions under which the bank is to hand over documents to the Buyer and receive payment, and (b) other documents (*e.g.* transport document, insurance document, certificate of origin, inspection certificate, etc.) as required by the buyer.

(3) Remitting Bank sends documents to Collecting Bank – The Remitting Bank sends the documentation package by mail or by courier to the Collecting Bank in the Buyer's country with instructions to present them to the Buyer and collect payment.

(4) The Collecting Bank reviews and provides documents to Buyer – The Collecting Bank (a) reviews the documents making sure they appear to be as described in the collection order, (b) notifies the Buyer about the terms and conditions of the collection order, and (c) releases the documents once the payment or acceptance conditions have been met. Acceptances under documentary collections are known as "Trade Acceptances" which, when accepted (by the Buyer), only carry the obligation of the buyer as opposed to a "Bankers Acceptance' commonly used under a letter of credit which carries the obligation of a bank.

(5) Buyer provides payment to Collecting Bank – The Buyer (a) makes a cash payment, or if the collection order allows, signs an acceptance (promise of the Buyer to pay at a future date) and (b) receives the documents and takes possession of the shipment.

(6) Collecting Bank provides payment to Remitting Bank – The Collecting Bank pays the Remitting Bank either with an immediate payment or, at the maturity date of the accepted bill of exchange if it receives payment from the Buyer.

(7) The Remitting Bank pays the Seller.

ANNEX 15-III

Proliferation financing - the relevant legal and regulatory obligations

1. The system of international and national counter-proliferation controls includes a framework of treaties and United Nations (UN) Resolutions, in particular UNSCR 1540 (2004), which 'universalised' export controls that were previously implemented mainly on a voluntary and national basis.

> ***Extract from Security Council Resolution 1540:***
>
> *3 Decides also that all States shall take and enforce effective measures to establish domestic controls to prevent the proliferation of nuclear, chemical, or biological weapons and their means of delivery, including by establishing appropriate controls over related materials and to this end shall: …*
>
> *(d) Establish, develop, review and maintain …… controls on providing funds and services related to such export and trans-shipment such as financing, ……*

General obligations: export controls versus financial controls

2. The general obligation on member states is to prevent the activities that UNSCR 1540 describes. Although UNSCR 1540 primarily requires implementation of export controls and does not specifically require states to establish an asset freezing regime, some jurisdictions have implemented national targeted financial sanctions as a route to meet finance-related obligations under UNSCR 1540.

3. Export controls are the primary counter-proliferation safeguard because:

- International regimes determine the nature of controlled goods - including *dual-use goods*
- Controlled goods require export licences from national authorities
- Licences are issued for specific end-users

4. The FATF has studied the specificities and functioning of export controls and the characteristics of international finance. It concluded that financial measures can supplement, but are not a substitute for effective export controls. This is in line with their Proliferation Financing Report, which concluded that financial measures could help in overall counter-proliferation efforts, but the benefit of these measures will be very limited if traditional counter-proliferation measures are not effectively implemented and enforced[25]. Export controls are focused on preventing the illegal transfer of proliferation-sensitive goods and may affect financial activity as a secondary effect. Financial measures can reinforce export controls by addressing aspects of an illegal transfer of proliferation-sensitive goods that take place outside the jurisdiction of the country where the illegal export has occurred, such as the financial activities of the associated front company or end-user located in a second jurisdiction.

5. The FATF Proliferation Financing Report sets out the key features and organisations involved in export control[26].

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[25] Proliferation Financing Report, paragraph 160.

[26] Proliferation Financing Report, paragraphs 115-122 and Annexes 4, 5 and 6.

Obligations in relation to financial controls

UNSCR

6. UN Security Council resolutions are addressed to member states, requiring them to take specific actions as regards the subject matter. They therefore do not in themselves directly impose obligations on firms. Member states are required to introduce domestic controls to prevent proliferation [1540(2004)] and specifically to take actions in relation to Iran [1737(2006), 1747(2007), 1803(2008) and 1929(2010)] and North Korea [1874(2009)].

EU

7. The EU has adopted a number of Regulations that have direct effect in the UK. For example:

- 961/2010 on Iran (which repealed 423/2007)
- 1283/2009 on North Korea

8. Regulation 423/2007 implemented the vigilance requirements in UNSCR 1803 in the European Union. UNSCR 1803 was adopted on 3 March 2008 because of the international community's serious ongoing concerns about Iran's nuclear development programme.

9. UNSCR 1803 calls upon all states to exercise vigilance over the activities of financial institutions in their territories with all banks domiciled in Iran and their branches and subsidiaries abroad, in particular with Bank Melli and Bank Saderat, in order to avoid such activities contributing to the proliferation-sensitive nuclear activities or the development of nuclear-weapon delivery systems referred to in UNSCR 1737.

10 Regulation 961/2010 repliactes the asset freezing measures contained in 423/2007, and implements additional restrictive measures against Iran, as set out in Council Decision 2010/413/CFSP, approved in July 2010.

11 Regulation 961/2010 sets out restrictions on the transfers of funds to and from an Iranian person, entity or body, and how transfers shall be processed.

Transfer value	**Requirements**
€10,000 or less	No requirements. These can be made as normal unless there are a series of transactions below €10,000 that appear to be linked. If this is the case, they should be notified to a competent authority.
More than €10,000 but less than €40,000	Must be **notified in advance** to a competent authority, whatever the transaction is for.
€40,000 or above	If they relate to foodstuffs, healthcare, medical equipment or humanitarian purposes, they must be **notified in advance** to a competent authority. They do not require prior authorisation from a competent authority.

If they are for any other purpose, they must be **submitted to a competent authority in advance for authorisation**. They cannot be undertaken without prior authorisation.

12. Article 23 of Regulation 961/2010 requires credit and financial institutions, in their activities with listed entities, to:

> a) exercise continuous vigilance over account activity particularly through their programmes on customer due diligence and under their obligations relating to money-laundering and financing of terrorism;
>
> b) require that in payment instructions all information fields which relate to the originator and beneficiary of the transaction in question be completed; and if that information is not supplied, refuse the transaction;
>
> c) maintain all records of transactions for a period of five years and make them available to national authorities on request; and
>
> d) if they suspect or have reasonable grounds to suspect that funds are related to proliferation financing, promptly submit a proliferation finance report to SOCA using the SAR format and process (see Part I, Chapter 6). In relation to the practical implementation of (b) above, Article 11a (1) (b) applies only to the payment remitting financial institution and the paying financial institution; it does not apply to intermediary financial institutions.

13. There is no facility in Regulation 961/2010 to seek consent to proceed with a transaction/activity when making a Proliferation Finance report. HM Treasury has issued a Guidance Note for Firms on Regulation 961/2010, available at http://www.hm-treasury.gov.uk/d/public_notice_reg961_271010.pdf

14. Regulation 961/2010 further widened the scope of the restrictive measures imposed under previous UN Security Council Resolutions, and introduced additional restrictive measures against Iran. Regulation 961/2010 extends the obligation to freeze funds of certain specified Iranian banks to include the funds of a range of persons, entities and bodies identified as involved in nuclear or ballistic missiles activity. These lists, at Annexes VII and VIII to Regulation 961/2010, includes all Iranian banks established in the UK.

15. Regulation 1283/2009 amends Regulation 329/2007 in respect of North Korea, in order to implement the provisions of UNSCR 1874(2009).

UK

16. The Iran (Financial Sanctions) Order 2007 (SI 2007/281) gives effect in the UK to the provisions of UNSCR 1737(2006). Under the Resolution, various persons are designated in an Annex and the Security Council and a committee of the Security Council (the "Committee") can designate further persons. Member states are required to take measures in respect of any designated person and any person or entity acting on his behalf or at his direction, or by entities owned or controlled by him. The measures include the freezing of funds, financial assets and economic resources of such persons and ensuring that any funds, financial assets and economic resources are not made available to them or for their benefit. The Security Council and the Committee can designate persons who are engaged in, directly associated with or providing support for Iran's proliferation-sensitive nuclear activities or the development of nuclear weapons delivery systems. The 2007 Order provides that the persons designated in the Annex to the Resolution, by the Security

Council, the Committee or the Treasury are designated persons for the purposes of the 2007 Order. The 2007 Order prohibits any dealing with funds, financial assets and economic resources of designated persons, or making funds, financial assets or economic resources available to designated persons. The 2007 Order makes it a criminal offence to contravene this prohibition.

17. In a similar way, the Iran (European Communities Financial Sanctions) Regulations 2007 (SI 2007/1374) provide for breaches of prohibitions which relate to certain financial sanctions set out in EU Regulation 423/2007 (as amended), and certain other acts and omissions, to be criminal offences. The UK Regulations also give HM Treasury the power to designate persons in addition to those listed under the EU Regulation.

18. In addition, the Counter-Terrorism Act 2008 gives HM Treasury powers, in response to terrorist or proliferation finance threats; to direct firms to carry out

- Enhanced due diligence
- Systematic reporting
- Limit or cease business

19 The Financial Restrictions (Iran) Order 2009 (SI 2009/2725), made under the Counter-Terrorism Act 2008, contains a direction requiring the UK financial services sector to cease all business with the Iranian Bank Mellat and the Islamic Republic of Iran Shipping Lines. The Treasury is satisfied, as required by the Act, that activity in Iran that facilitates the development or production of nuclear weapons poses a significant risk to the national interests of the UK. This means that from 12 October 2009, financial and credit institutions are no longer able to enter into new transactions or business relationships with these entities, nor to continue with existing transactions or business relationships, unless they are licensed by HM Treasury.

20. Guidance on complying with directions issued under the CTA is given in Part III, section 5.

ANNEX 15-IV

(Paragraph 15.28)

WITTING AND UNWITTING ACTORS

[EXTRACT FROM FATF FEBRUARY 2010 WORKING GROUP REPORT]

Proliferators abuse typical trade structures to facilitate their activities, which include supporters, financiers, logistical support, front companies, assets, shippers and facilitators. Entities that are knowingly engaged in proliferation, such as a front company, may also be involved in legitimate business. Other actors used by a network may knowingly support proliferation, be "wilfully blind" that they are being used for illicit purposes, or are truly unwitting actors. When an entity is engaged in both legitimate and illicit trade it may be less likely for financial institutions to suspect illegal activity.

Front and Other Companies

In individual cases, proliferation networks have employed companies to conceal the true end-use or end-user of traded goods. Most front companies are sensitive to public exposure and disruption of legitimate activities.

Front companies established by proliferators conduct transactions similar to those of companies engaged in legitimate business. Front companies used by proliferators may be similar to those established by money launderers. As is the practice of other criminal organisations, proliferators create companies for a seemingly legitimate commercial purpose and commingle illegal funds with funds generated by legal commercial activity. In some cases, front companies established by proliferators do not engage in any legal activity at all. Front companies may use fraudulent accounting practices and establish various offshore entities in jurisdictions with lax controls to disguise illegal operations. Proliferators are also known to change the names of front companies, or to use multiple names for the same front company, to prevent the detection of the companies' association with proliferation – or other illicit activity.

Front companies used by proliferators are often located in a major trading hub of a foreign jurisdiction with lax export controls, but may also be found in jurisdictions with more established controls. They can be shell corporations with a fictitious business and physical location or can have normal commercial and industrial operations.

Front companies can arrange shipping services, routing or re-routing goods acquired by the importer or its intermediary. The same and/or additional companies can also be located in jurisdictions with weak financial controls, enabling related financial transactions to settle the underlying trade without detection.

In exceptional cases, front companies may seek complicity within a particular jurisdiction's government for signoff by national authorities, by production of false cargo manifests to misdirect customs, law enforcement, and intelligence as to the true nature of the goods being exported and their end-use.

Brokers

Brokers are involved in the negotiation or arrangement of transactions that may involve the transfer of items (often between third countries) or who buy, sell or arrange the transfer of such items that are in their ownership. In addition they may also become involved in ancillary activities that facilitate the movement of items such as, but not limited to: *i)* providing insurance; *ii)* marketing; *iii)* financing; and *iv)* transportation / logistics. Illicit brokers illegally participate in proliferation by circumventing existing controls and obfuscating trade activities.

Brokers used by proliferation networks are often individuals relying on simple commercial structures, who are very mobile (financially and geographically) so that they can operate from any jurisdiction.

Other Intermediaries

Intermediaries may include companies and individuals that purchase or sell sensitive goods for further manufacture or redistribution. Intermediaries may have a particular knowledge of a jurisdiction's commercial infrastructure. Intermediaries that are knowingly engaged in proliferation will use this knowledge to exploit vulnerabilities in export control systems to the advantage of the proliferator.

Financial Institutions

Proliferation networks may use financial institutions to hold and transfer funds, settle trade and pay for services. Proliferation networks may use both private and public financial institutions for international transactions. States seeking to acquire WMDs may also use foreign branches and subsidiaries of state-owned banks for proliferation finance-related activities, giving these institutions the responsibility of managing funds and making and receiving payments associated with proliferation-related procurement or other transactions. These subsidiaries may be engaged in both legitimate and illegitimate transactions.

ANNEX 15-V

FATF's Trade-Based Money Laundering "Red Flag" Indicators

The respondents to the FATF project team's questionnaire reported a number of red flag indicators that are routinely used to identify trade-based money laundering activities. These include situations in which:

- Significant discrepancies appear between the description of the commodity on the bill of lading and the invoice.
- Significant discrepancies appear between the description of the goods on the bill of lading (or invoice) and the actual goods shipped.
- The size of the shipment appears inconsistent with the scale of the exporter's or importer's regular business activities.
- The type of commodity being shipped is designated as "high risk" for money laundering.*
- The type of commodity being shipped appears inconsistent with the exporter's or importer's regular business activities.
- The shipment does not make economic sense.**
- The commodity is shipped to (or from) a jurisdiction designated as "high risk" for money laundering activities.
- The commodity is transhipped through one or more jurisdictions for no apparent economic reason.
- The method of payment appears inconsistent with the risk characteristics of the transaction.***
- The transaction involves the receipt of cash (or other payments) from third party entities that have no apparent connection with the transaction.
- The transaction involves the use of repeatedly amended or frequently extended letters of credit; and
- The transaction involves the use of front (or shell) companies.

[Customs agencies make use of more targeted information that relates to specific exporting, importing or shipping companies. In addition, red flag indicators that are used to detect other methods of money laundering could be useful in identifying potential trade-based money laundering cases.]

* For example, high-value, low volume goods (e.g. consumer electronics), which have high turnover rates and present valuation difficulties.
** For example, the use of a forty-foot container to transport a small amount of relatively low-value goods.
*** For example, the use of an advance payment for a shipment from a new supplier in a high-risk country.

ANNEX 15-VI

Proliferation financing - Risk assessment of customers and products

1. The purpose of a risk-based approach is not the elimination of risk but rather that firms involved in high risk activity understand the risks they face and have the appropriate policies, procedures and processes in place to manage such risk. Equally, even reasonably applied controls will not identify and detect all instances of proliferation.

2. It would be impractical for firms to be expected to develop a dedicated risk-assessment framework for assessing proliferation financing risks alone. It would be more proportionate to include proliferation considerations alongside the wider determination of risks factors. Moreover, established mechanisms to conduct risk assessment and to identify suspicious activity of wider criminal activity are, in many cases, likely to be applicable to proliferation considerations.

3. The application of a risk-based approach to proliferation financing has both similarities to, and differences from, money laundering. They both require a process for identifying and assessing risk, but the characteristics of proliferation financing – including the limited availability of accessible information to determine risk – result in a more restricted scope for the application of risk-based measures. In acknowledgement of such limitations this guidance seeks to identify potential areas where risk-based decisions could be applied in the area of proliferation financing.

4. Clearly, in some circumstances a risk-based approach will not apply, will be limited, or will be determined by the parameters set by international obligations, national law or regulation. Where particular individuals, organisations or countries are subject to proliferation sanctions, the obligations on firms to comply with certain actions are determined exclusively by national authorities and are therefore not a function of risk. A risk-based approach may, however, be appropriate for the purpose of identifying evasion of sanctions, for example, by directing resources to those areas identified as higher risk.

5. The inclusion of proliferation financing within current risk assessment practices should be proportionate to the overall proliferation risk associated with the activities undertaken by the firm. For example, a firm operating internationally and/or with an international client base will generally be expected to assess a wider range of risks, including proliferation, than a smaller, domestically-focused one.

6. In the application of a risk-based approach, measures and controls implemented by firms may often address more than one identified risk, and it is not necessary that a firm introduce specific controls for each risk. For instance, risks associated with proliferation financing are likely to sit alongside other country, customer and product risks. Additional information that may be useful could include further information on the parties to a transaction, source of funds, beneficial ownership of the counterparty and purpose of the transactions or payment.

Country/geographic risk

7. The most immediate indicator in determining risk will be whether a country is subject to a relevant UN sanction (i.e. Democratic People's Republic of Korea (DPRK), Iran); in these instances some element of mandatory legal obligation will be present, along with risks related to sanctions evasion by sanctioned entities, and proliferation financing by unsanctioned entities. Depending on the extent of risk assessment and business conducted, other factors that may be considered could include:

- Countries with weak or non-existent export controls (the FATF Proliferation Financing report noted that only 80 jurisdictions have any exports controls related to WMD). Individual country

compliance with export control obligations are not, however, currently published. In the absence of such information, firms will not be in a position to make an informed assessment and therefore will not be in a position to utilise this indicator. If, however, such information became forthcoming – either at an international or individual government level – it could provide an additional factor that could potentially inform country risk assessment.

Customer risk

8. Any assessment of the risks that a customer may pose will be underpinned by customer take-on procedures and developed further by ongoing monitoring. Specific categories of customer whose activities may indicate a higher proliferation financing risk could include:

- Those on national lists concerning high-risk entities. For example, the UK's Iran End Users list identifies over 100 entities that may potentially pose a proliferation concern[27]. Importantly, such types of lists are not embargo lists, but rather they highlight entities which pose an elevated concern.

- Whether the customer is a military or research body connected with a high-risk jurisdiction of proliferation concern.

- Whether the customer is involved in the supply, purchase or sale of dual-use and sensitive goods. Firms rely on export control regimes and customs authorities to police the activities of exporters who are their customers. Among others, export control authorities and customs authorities ensure that licensing requirements for dual-use goods have been met. Therefore, the fact that a customer is involved in the supply, purchase or sale of dual-use goods is, of itself, not an indicator for a firm; this would result in a disproportionately large number of trading companies falling into this category. However, a wide range of industrial items and materials can assist WMD programmes and would-be proliferators. The most critical items normally appear on national strategic export control lists, although screening against controlled goods lists is not a practical solution for firms. The involvement in the supply, purchase or sale of dual-use goods may therefore be of some relevance if other risk factors have first been identified.

9. Mitigating factors should also be considered, for example whether the customer is itself aware of proliferation risks and has systems and processes to ensure its compliance with export control obligations.

Product and Service Risks

10. Determining the risk of products and services may include a consideration of factors such as:

- Delivery of services to certain entities i.e. correspondent banking to Iranian institutions identified in EU Regulation 1110/2008 or correspondent banking to countries subject to relevant UN Sanctions.
- Project financing of sensitive industries in high-risk jurisdictions.
- Trade finance services and transactions involving high-risk jurisdictions.

11. As is the case with anti-money laundering, any assessment of risk will need to take account of a number of variables specific to a particular customer or transaction. This will include duration of relationship, purpose of relationship and overall transparency of relationship and/or corporate structure. It would be disproportionate to assess a stable, known customer who has been identified

[27] http://www.berr.gov.uk/whatwedo/europeandtrade/strategic-export-control/licensing-policy/end-use-control/page29307.html

as involved in the supply, purchase or sale of dual-use and sensitive goods as either moderate or high-risk for that reason alone. However, the overall assessment of risk may increase with the presence of other factors i.e., delivering high volumes of dual-use or sensitive goods to a high-risk country/complicated corporate structures/the type and nature of principal parties engaged in the transaction. Consideration of these risks, including customer-specific information, and mitigating factors, will enable a firm to reach a graduated understanding of the degree of proliferation finance risk a particular customer poses.

12. Interpretation of "dual-use" requires a degree of technical knowledge that letter of credit document checkers cannot be expected to possess. In addition, the description of the goods may appear in the documents using a wording which does not allow the identification of such goods as "dual-use". Regardless of the details in the information sources, however, without the necessary technical qualifications and knowledge across a wide range of products and goods, the ability of a firm to understand the varying applications of dual-use goods will be virtually impossible. It would be impracticable for firms to employ departments of specialists for this purpose.

13. Firms may nevertheless refer to sources of information that may be relevant to assessing the risk that particular goods may be 'dual-use', or otherwise subject to restrictions on their movement. For example, there are public resources (such as the EC's TARIC database) that can indicate which restrictions might apply to exports from the EU with specific tariff codes: it will show where trade in some types of good under that category might be licensable or prohibited. Exporters must already provide tariff codes to the customs authorities (who use them to calculate the tax levied on the trade), so should be able to provide them to their banks, insurers and their agents. These can be used to identify transactions that might present higher risk or require further due diligence checks, particularly in situations where the risks are perceived to be higher). For example, have issuing banks, applicants or beneficiaries of letters of credit, or freight companies and shipping lines moving the goods, been highlighted by national authorities as being of concern? (This information will often be recorded on commercially-available due diligence tools). Does the trade involve jurisdictions previously implicated in proliferation activity?

14. UK exporters seeking to send goods to countries subject to trade restrictions may also be in contact with the Export Control Organisation of the Department for Business Innovation and Skills to clarify whether their shipments will be affected. A firm financing trade with such countries may inquire whether such correspondence has been entered into, particularly if it appears that the goods in question may require an export licence.

15. The Export Control Organisation provided additional guidance in a letter addressed to the British Bankers' Association in June 2011. An extract from the guidance received is as follows:

The basic rules

As of 6th June 2011, we are no longer offering the 'Rating Enquiry Service'. Instead, we are now providing two new distinct advice services, namely

- the 'Control List Classification Advice Service' and
- the 'End User Advice Service', now extended beyond Iran to cover all countries except EU Members States, Australia, Iceland, Norway, Japan and United States of America.

The logic of this is primarily to ensure that the many exporters who are fully aware that their goods do not feature on any control lists (and will therefore only be prevented from export on the basis of WMD concerns) can swiftly obtain the WMD end user advice they need rather than having to go through the full technical rating process every time. Under the new system, an exporter on making a new 'Control List Classification' enquiry about their goods, software or

technology, will either be told that their goods are controlled and a licence needed, or will receive a 'Not Listed' outcome letter; advice which they can retain to avoid having to make repeat enquiries. Exporters with "Not Listed" advice can then ask us about the end user(s) of any future exports by making an 'End User Advice' enquiry and will either be told that they need to apply for a licence on the basis of WMD concerns, or receive a 'No concerns' outcome letter. Please see the enclosed 'Notice to Exporters' from our website for more information:-

http://www.bis.gov.uk/assets/biscore/eco/docs/notices-to-exporters/2011/nte201113.doc

Implications for banks

ECO will deal with any Rating Enquiries that were submitted before 31st May 2011 and will be finalising a backlog of Rating Enquiries over the coming weeks. So whilst some of the traditional Rating letters will continue to be issued, they will increasingly be superseded by the new advice. As a result, where banks see a need to confirm that exports do not cause governmental concern, they can, under the new system, reasonably ask exporters to provide either:

i. a valid export licence; or

ii. a 'Not Listed' letter from the Control List Classification Advice Service accompanied by a 'No concerns' letter from the End User Advice Service confirming that there are no WMD concerns relating to the proposed recipient of the export

If exporters are not able initially to provide either of the above, then banks should first ask them to confirm that they have taken appropriate steps to confirm that their goods are 'not listed'. If exporters are unclear about whether their goods are listed, they will need to first ascertain this before approaching the End User Advice Service. They can do this by consulting the ECO website as above, using an outside consultant, or by making a Control List Classification enquiry. All these methods are equally valid and exporters should not be encouraged to make a Control List Classification enquiry on the basis that it is more authoritative. When exporters have established that their goods are not listed, they should then apply for advice under the End User Advice Service as above and furnish the positive response to the bank when they receive it.

It is of course entirely understandable that banks should seek reassurance about the business they are supporting when it involves high risk destinations where WMD issues come into play. ECO fully supports you in that endeavour, our concern is simply to ensure that you seek the right evidence to reflect the new systems and thus gain that reassurance in the most appropriate and effective way.

The ECO's Helpline contact details are 020 7215 4594 or eco.help@bis.gsi.gov.uk

For more information on export controls, see http://www.businesslink.gov.uk/exportcontrol or http://www.bis.gov.uk/exportcontrol .