Financial Action Task Force Groupe d'action financière

FATF Report

COMBATING PROLIFERATION FINANCING:

A STATUS REPORT ON POLICY DEVELOPMENT AND CONSULTATION

February 2010

THE FINANCIAL ACTION TASK FORCE (FATF)

The Financial Action Task Force (FATF) is an independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering and terrorist financing. Recommendations issued by the FATF define criminal justice and regulatory measures that should be implemented to counter this problem. These Recommendations also include international co-operation and preventive measures to be taken by financial institutions and others such as casinos, real estate dealers, lawyers and accountants. The FATF Recommendations are recognised as the global anti-money laundering (AML) and counter-terrorist financing (CFT) standard.

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I. Introduction

1. The Working Group on Terrorist Financing and Money Laundering (WGTM) Project Team on Proliferation Financing (PFPT) was created in October 2008 to develop policy options for the WGTM to consider as measures that could be considered in combating proliferation financing within the framework of existing United Nations Security Council Resolutions (UNSCRs), such as UNSCR 1540(2004), in consideration of the Proliferation Financing (PF) Typologies Report[1] and national legal frameworks. This work is to build on the Issues for Consideration as outlined in the PF Typologies Report, and be conducted with input from the private sector and other relevant stakeholders (see PFPT Terms of Reference).

2. The PF Typologies Report, adopted by the FATF in June 2008, has formed the starting point for the Project Team's consideration. In particular, the report assembled information needed as a basis for work by the PFPT. The current project has expanded this work through further information-gathering concentrated on information provided by the private sector and export control experts. The analysis of this information has led to further examine and give flesh to the policy options which were sketched in the PF Typologies Report.

3. In particular, the key issues and challenges identified by the PF Typologies Report are: *i)* legal systems, *ii)* awareness-raising with both public and private sectors, *iii)* preventive measures, and *iv)* investigation and prosecution.

4. The PFPT's terms of reference were defined initially as follows:

- The Project Team will develop policy options for the WGTM to consider as measures that could be considered in combating proliferation financing within the framework of existing UNSCRs, such as UNSCR 1540(2004), in consideration of the PF Typologies Report and national legal frameworks. This work should build on the Issues for Consideration as outlined in the PF Typologies Report.

- The Project Team will actively seek input and comments from the private sector and other relevant stakeholders.

- The Project Team should strive to narrow down the number of options for the full working group (WGTM), but has no mandate to make final decisions; its findings will be fully discussed and considered by the full working group with a view to determining what further steps would be appropriate.

- To ensure maximum transparency, the Project Team leaders will provide to the Secretariat all documents underlying the team's work (including a team contact list, analysis of research findings and private sector feedback received) for upload to the WGTM secure website. Additionally, the Project Team will update the full working group, including through written summaries, at the February and June 2009 WGTM meetings.

- Under the leadership of one or two interested delegations, the work of the Project Team will be guided by a project plan, including a timetable for completion of the work.

- The Project Team will present its final report to the WGTM in October 2009.

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

Box 1: Financial provisions of UNSCR 1540 (2004):

2. Decides also that all States, in accordance with their national procedures, shall adopt and enforce appropriate effective laws which prohibit any non-State actor to manufacture, acquire, possess, develop, transport, transfer or use nuclear, chemical or biological weapons and their means of delivery, in particular for terrorist purposes, as well as attempts to engage in any of the foregoing activities, participate in them as an accomplice, assist or finance them;

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 appropriate effective national export and trans shipment controls over such items, including appropriate laws and regulations to control export, transit, trans-shipment and re-export and controls on providing funds and services relate to such export and trans-shipment such as financing, and transporting that would contribute to proliferation, as well as establishing end-user controls; and establishing and enforcing appropriate criminal or civil penalties for violations of such export control laws and regulations;

5. The Project Team's mandate derives from UNSCR 1540 and the framework of UNSCRs that are relevant to a consideration of proliferation financing. The Project Team has concentrated on the obligations required by UNSCR 1540, and has highlighted where policy options relate directly to those obligations. We have looked at the scope of UNSCR 1540 in a broad perspective. This report therefore also considers counter proliferation financing in the wider context of international Conventions, Treaties and Security Council Resolutions.

6. In addition to UNSCR 1540, a number of other UNSCRs can have some relevance, including UNSCR 1673(2006); and 1810(2008) on non-proliferation in general; and resolutions related to specific countries of proliferation concern, such as UNSCRs 1695(2006); 1718(2006); and 1874(2009) on North Korea; and UNSCRs 1737(2006); 1747(2007); and 1803(2008) on Iran will be relevant where applicable. Previous consideration of these resolutions by the FATF has produced guidance which remains relevant in the context of the specific proliferation risks covered by these UNSCRs, in particular the guidance produced by the FATF in relation to UNSCRs 1718, 1737 and 1803. However, the requirements of UNSCRs 1737 and 1803 differ from those of UNSCR 1540, so the guidance will not read-across to proliferation finance in general.

7. There is at present no standard, universal definition of proliferation or proliferation financing common to the relevant international regimes and fora. The broad working definition used in the PF Typologies Report was the initial basis for the work of the Project Team. Based on the latter definition, the Project Team has proposed the following revised definition of proliferation financing for FATF purposes as set out in Section III below:

"Proliferation financing" *refers to:*

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[2].

[2] This definition is of an *act* of proliferation financing and therefore does not refer to knowledge, intention, or negligence. However, when a jurisdiction specifies the responsibilities of financial institutions or a possible criminal offense of proliferation financing, the legal principles governing these two regimes in that jurisdiction will apply, including the roles of knowledge, intention, or negligence.

8. The Project Team has held meetings in Paris on 22 February 2009; a 2-day intersessional meeting in London on 15-16 April 2009; in Lyon on 21 June 2009; and a 2-day intersessional meeting in Geneva on 10-11 September 2009. Further work has been conducted by email and conference calls, and via the WGTM's secure website.

9. Engagement with outside stakeholders and experts, including from the private sector, export control sector, and other competent state authorities, is essential to consideration of proliferation finance issues. The work to prepare the PF Typologies Report developed a strong and productive relationship with private sector experts, which the Working Group on Typologies (WGTYP) agreed and highlighted the importance of further consultation with the private sector, including with small and medium scale financial institutions (FIs) (WGTYP Co-Chairs report, June 2008). In keeping with its mandate, the PFPT has actively sought the participation of outside experts in its work – with one day of the London meeting being set aside to consult experts from Export Control organisations and FIs.

10. Private sector and export control experts have made themselves available for consultation by the Project Team. They have provided advice throughout this project which has made a significant and highly valuable contribution to the work of the Project Team. According to the mandate of the group, continued engagement with the private sector; export control organisations and other stakeholders is essential in this field.

II. The International Response to Proliferation Financing

11. Proliferation financing facilitates the movement and development of proliferation-sensitive items and as such, can contribute to global instability and potentially catastrophic loss of life if weapons of mass destruction (WMD) are developed and deployed. As set out in the PF Typologies Report, proliferators operate globally and mask their acquisitions as legitimate trade. They exploit global commerce, for example by operating in countries with weak export controls or utilising free-trade zones, where their illicit procurements and shipments are more likely to escape scrutiny.

12. Proliferators abuse both the formal and informal sectors of the international financial system or resort to cash in order to trade in proliferation relevant goods. It should be noted that organized networks, such as that run by A.Q. Khan, which make use of the formal international financial system, may be easier for authorities to detect than those using informal sectors. When abusing the formal international financial system, purchases must appear legitimate to elude suspicions, as proliferation-sensitive goods and services may be purchased on the open market. Proliferation networks also use ordinary financial transactions to pay intermediaries and suppliers outside the network. Proliferation support networks therefore use the international financial system to carry out transactions and business deals, often acting through illicit intermediaries, front companies and illegal trade brokers. These procurement networks have become significantly more complex over time, increasing the probability that the true end-users of proliferation sensitive goods will avoid detection. FIs are usually unwitting facilitators of proliferation.

The Role of Export Control Systems

13. An extensive and sophisticated system of international and national counter-proliferation controls has been developed by interested governments over the past four decades. This includes a framework of: treaties and United Nations (UN) Resolutions, in particular UNSCR 1540 which is the first to universalise export controls that were previously implemented mainly on a voluntary and national basis. Other elements include non proliferation treaties (in particular the Nuclear Non Proliferation Treaty (NPT), the Biological and Toxin Weapons Convention (BTWC), the Chemical Weapons Convention (CWC)). This framework also comprises international organisations including the International Atomic Energy Agency (IAEA); international export control regimes such as the Nuclear Suppliers Group (NSG) or the Missile Technology

Control Regime (MTCR) and national authorities responsible for administering and enforcing export controls, including export licensing, customs and law enforcement authorities, and intelligence agencies. The PF Typologies Report sets out the key features and organisations involved in export control[3].

14. The links between proliferation finance measures and the existing elements of the export control system are particularly important and crucial to the successfulness of the whole framework. Many of the policy options for countering proliferation finance draw on resources already available through the export control system, or are dependent on information or legal authorities which is available only from export control authorities. As well, export control authorities have noted that financial information may in some cases be helpful to them as a way to trace critical end-users or illicit transactions.

15. The Project Team has studied in depth the specificities and functioning of export controls and the characteristics of international finance. It has concluded that financial measures are an important supplement to, but not a substitute for, effective export controls. This is in line with the PF Typologies 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[4]. Financial measures are useful in that they specifically address the financial activity associated with proliferation, while 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.

16. The close relationship between safeguards against proliferation finance and export control systems carries some risks which we should seek to avoid:

- Overlaps: duplication of responsibilities on both the export control side (exporters or export control authorities); and financial side (banks or competent authorities including financial intelligence units (FIUs)) could waste efforts better spent on other controls. Given the specificities of international financial flows and the characteristics of international trade financing, it is not possible to expect from FIs the same sort of controls that are mandatory for exporters prior to export of dual use items listed in international export control regimes.

- Issues posed by countries without export controls or with weak implementation of export controls: As noted in the PF Typologies Report, efficient export control is a key element in combating proliferation. However, Reports to the UN 1540 Committee suggest that about 80 (out of 192) countries apply export controls, and among those countries which do have export controls there are varying levels of implementation. An effective export control system requires a clear understanding of proliferation sensitive goods listed in publicly available documents. Because of FIs limited insight and expertise into the underlying transaction, the effectiveness of financial measures depends in-part on the possibility to resort to national export control authorities in case of doubt. Countries without export controls will thus find it harder to implement measures to counter proliferation finance, as they will lack the relevant awareness, legal framework, and specialised organisational capacity. If proliferation finance measures were wholly dependent on the existence of a national export control authority, they would be more difficult to apply and less effective in those countries without effective export control regimes, potentially creating gaps in the global implementation of such measures.

[3] PF Typologies Report, paragraphs 115-122 and Annexes 4, 5 and 6.

[4] PF Typologies Report, paragraph 160.

- Inconsistency: given the globalisation of trade and of finance, controls need to be implemented worldwide to be most effective. Proliferators have a high degree of choice over the jurisdiction in which to locate their financial operations, and may use jurisdictions which do not implement measures to counter proliferation financing to evade such controls.

17. Mis-allocation of responsibility is a significant risk. Several FIs consulted by the Project Team and some Project Team members have highlighted the risk that FIs could be required to exercise vigilance over transactions in a way that outstrips their practical capability or the information available. In these circumstances, their response could be to:

- Refuse new business with high-risk customers, or cease existing business with them. This could potentially mean ceasing to do business with an entire manufacturing sector, or a country which was proliferation-sensitive; and could cause far-reaching disruption of legitimate, lawful financial transactions. That consequence can be examined under a wider policy perspective (*e.g.* establishment of an undesired de facto embargo).

- Transfer the liability back to the export control authorities; by requiring authorisation from export control authorities before proceeding with any transactions in respect of high-risk export sectors or countries – for example by requesting a "non-objection letter" that certifies that no export license is needed. However, this would underestimate the responsibility of the large majority of exporters who strive to respect the law and apply for an export licence in case of doubt about the end-user before exporting the goods, and thus lead to a duplication of controls. Furthermore, such requests may lead to a multitude of requests that more than exceeds export control authorities' capacities and therefore disrupt legitimate trade as well as divert export control authorities away from scrutinising suspicious exports, and towards providing assurances regarding non-suspicious goods.

18. The policy options set out in this report can to some extent mitigate these risks. Some policy options are therefore interdependent, for example ensuring that sufficient information is provided to FIs to enable them to meet their obligations.

Scope for Financial Measures to Counter Proliferation

19. There are several routes by which countries can meet the specific obligations to counter proliferation financing established by UNSCR 1540. The Project Team has attempted to articulate a shared understanding of these obligations, and set out the practical measures through which they can be met. UNSCR 1540 requires jurisdictions to take "effective measures to establish domestic controls to prevent the proliferation of nuclear, chemical, or biological weapons and their means of delivery...". There is some potential for financial measures to contribute to several different practical counter-proliferation objectives, both within UNSCR 1540 and more broadly:

- To prevent the provision of financial services for the development of weapons of mass destruction and their means of delivery.

- To prevent financing for individual shipments related to WMD proliferation.

- To contribute to stopping funding and to seizing funds under specific circumstances if sufficient information is available on time.

- To protect the international financial system from abuse by proliferators.

- To provide financial investigative support to existing counter proliferation investigation systems.
- To hinder the financial activities of proliferators to the extent possible.
- To the extent possible, to contribute to the identification and disruption of proliferation networks.

20. Setting the right level of ambition for proliferation finance measures means balancing the burden these place on governments and the private sector (exporters and FIs) with the impact on the threat from WMD proliferation. It should be kept in mind in this respect that the prevention of proliferation and of proliferation financing of nuclear, chemical and biological weapons should not hamper international cooperation in materials, equipment and technology for peaceful purposes. It is not possible at this time to give a rigorous assessment of the cost-effectiveness of counter-proliferation finance measures. However, the Project Team has attempted to identify those measures which are risk-based; proportionate in their impact; and cost-effective when viewed alongside the requirements export control regimes already places on the exporters. The Project Team has therefore endeavoured to seek various policy alternatives in this report in order to allow, to the extent possible, for a cost-effectiveness analysis including all abovementioned aspects. The focus is on identifying measures which can be implemented by FATF members, preferably without requiring major new capacity or significant disruption to existing government structures and thereby keeping in mind the administrative burdens to the financial sector in relation to the expected results of the proposed policy.

21. The conclusions set out in this report are policy options for consideration by the WGTM, as the PFPT does not have a mandate to make decisions. This report also sets out the detailed considerations of the group on each policy option, as background to discussion by the WGTM, and to assist jurisdictions in their consideration of national measures for combating proliferation finance, by articulating the options available, how they interrelate, and the costs, benefits, risks, and prerequisites for each of them.

III. Legal Systems

22. There are a number of questions about the legal meaning of "proliferation financing", including how proliferation and proliferation financing are defined, whether and on what basis and to what extent proliferation financing can be criminalised; how jurisdictions can implement the measures that they are required to undertake under UNSCR 1540, including whether these obligations include issues of asset freeze and asset forfeiture; rendering mutual legal assistance; extradition and information-sharing.

23. This broad theme also includes the availability of financial information and financial investigation techniques for use in the investigation and prosecution of counter-proliferation cases. We have also discussed how existing legal controls against proliferation financing could be integrated with those against money laundering and terrorist financing, and whether and how this may enable recourse to the FATF Recommendations and Special Recommendations.

Definition of Proliferation Financing

24. There is at present no internationally agreed definition of "proliferation" or of "proliferation financing". As a basis of this report, we have started off with the same broad working definition used in the PF Typologies Report, noted above.

25. Though this definition is adequate for the purposes of considering policy options in this report, the lack of an internationally agreed definition of proliferation and proliferation financing may leave jurisdictions responsibilities unclear, and may allow inconsistent approaches by different jurisdictions, which would compromise the effectiveness of multilateral responses to the threat of proliferation, and

opens a risk that different and incompatible national definitions of proliferation will be established, which could hinder international legal co-operation.

26. In the absence of an internationally agreed definition of proliferation financing there is - at the outset - scope for the FATF to adopt a shared definition for the purpose of developing measures to counter such activity. A definition agreed by the FATF would of course be non-binding on other international fora or organisations.

27. There are several considerations which the Project Team has agreed should be reflected in the definition of "proliferation financing". These include:

- An FATF definition should take into account that proliferation can involve both states and non-state actors. However, it is difficult to capture the duties of state and non-state actors in a definition[5].

- A definition should exclude trade in arms and dual-use goods for legitimate purposes.

- The definition of an ***act*** of proliferation financing need not refer to knowledge, intention, or negligence. However, when a jurisdiction specifies the responsibilities of FIs or a possible criminal offence of proliferation financing, the legal principles governing these two regimes in that jurisdiction will apply, including the roles of knowledge, intention, or negligence. (see next section).

- A definition should not be limited to providing funds, but also include the provision of various connected financial services. The report primarily focuses on financial transactions. The term “financial services”, however, is not limited to financial transactions.

- A definition should be consistent for all FATF Members, and should therefore be grounded in universal international obligations such as the UN resolutions.

- In addition to chemical, biological and nuclear weapons; a definition should encompass their means of delivery[6], and "related materials", which as defined by UNSCR 1540 includes technologies, and dual-use goods.

- A definition should include the range of activities set out in UNSCR 1540 and related resolutions, including the "manufacture, acquisition, possession, development, export, trans-shipment, transport, transfer, stockpiling, or use" of such items.

28. The Project Team has considered various options in its endeavour to provide a definition of proliferation financing. The Project Team's discussion has converged on the following provisional definition:

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5 Non-state actors are not addressees of international treaties or UNSCRs such as UNSCR 1540. Their duties are defined in national legislation, if existent. In the case of state actors, it is hard to distinguish between legal and illegal actions. *E.g.* it is unclear whether international obligations stemming from the relevant treaties (in particular the NPT, the BTWC, the CWC) are also binding for non-signatory states. There was a view in the project team that non-signatory states are under no obligation under these treaties. There was another view that these treaties establish objective and generally binding obligations for non-signatory states also.

6 UNSCR 1540 defines "means of delivery" as missiles, rockets and other unmanned systems capable of delivering nuclear, chemical or biological weapons, that are specially designed for such use.

"Proliferation financing" refers to:

> ***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[7].***

<u>Policy Options for Consideration</u>

- ***The FATF should consider this provisional definition as a basis for further work on proliferation financing.***

Criminalisation of Proliferation Financing

29. The PF Typologies Report identified criminalisation as an issue where several different approaches were taken by jurisdictions. We have considered whether the activity of proliferation financing should be criminalised; whether this should be through a specific offence; and whether jurisdictions should adopt a common approach to these questions.

30. The starting point is an examination of jurisdictions' existing obligations. UNSCR 1540 requires countries to:

"(2) *...in accordance with their national procedures, shall adopt and enforce appropriate effective laws which prohibit any non-State actor to manufacture, acquire, possess, develop, transport, transfer or use nuclear, chemical or biological weapons and their means of delivery, in particular for terrorist purposes, as well as attempts to engage in any of the foregoing activities, participate in them as an accomplice, assist or finance them;*

(3) (d) *Establish, develop, review and maintain appropriate effective national export and trans-shipment controls over such items, including appropriate laws and regulations to control export, transit, trans-shipment and re-export and controls on providing funds and services related to such export and trans-shipment such as financing, and transporting that would contribute to proliferation, as well as establishing end-user controls; and establishing and enforcing appropriate criminal or civil penalties for violations of such export control laws and regulations.*"

31. The PF Typologies Report examines the main requirements of UNSCR 1540. While the resolution sets out multiple broad obligations, it does not obligate states to impose criminal rather than civil obligations. States are required to determine how best to implement the requirements of the UNSCR 1540, in accordance with their domestic laws and regulations and consistent with international law.

32. As an expert from the UN 1540 Committee has clarified, UNSCR 1540[8] does not require that states specifically criminalise proliferation finance: in both of the provisions relating to the financing of proliferation, it is viewed in an ancillary capacity. There are a number of ways in which a jurisdiction

[7] This definition is of an *act* of proliferation financing and therefore does not refer to knowledge, intention, or negligence. However, when a jurisdiction specifies the responsibilities of financial institutions or a possible criminal offence of proliferation financing, the legal principles governing these two regimes in that jurisdiction will apply, including the roles of knowledge, intention, or negligence.

[8] PF Typologies Report, paragraphs 130-135.

could achieve what UNSCR 1540 requires. The UN expert made the point that UNSCR 1540 requires a given result ("*obligation de résultat*") but does not prescribe the means to achieve it ("*obligations de moyens*"). Specific criminalisation is one. Ancillary offences or civil penalties are also sufficient to meet the requirements of UNSCR 1540.

33. According to data compiled by the 1540 Committee, 95 UN member states have at least one measure that penalizes financing related to illicit proliferation-related acts by non-state entities. However, only 32 of these states, including 15 of the 31 FATF members that are also UN member states, penalise proliferation financing related to illicit trade, with 31 of these States criminalising such violations. Of the 32 states with criminal sanctions, 23, including 8 FATF – UN member states, criminalise the financing of such illicit trade transactions using their laws against terrorism or anti-money laundering, rather than laws based on non-proliferation objectives.

34. Some jurisdictions have chosen to create a specific offence of proliferation financing. Some arguments that have been put forward in favour of such an approach include:

- Enhancing enforcement against proliferation and proliferation financing.
- Raising awareness and helping to clarify the obligations on individuals, firms and FIs to be vigilant to proliferation and proliferation financing.
- Establishing a national definition of proliferation financing.
- Providing a basis, if required within a country's legal framework, for suspicious activity reporting.

35. Other states that have established a primary offence which includes proliferation financing, have either: criminalised proliferation financing as an integral component of a proliferation offence; or have criminalised providing any assistance to proliferation (*e.g.* providing financing, technical assistance or brokering). Key considerations for this approach are:

- Consistent treatment of all assistance to proliferation. Some PT members are concerned that specific criminalisation of proliferation financing may make other forms of assistance appear less condemnable.
- Enhancing enforcement against proliferation and any act of assistance of it including proliferation financing.
- Avoiding the need to change criminalisation to adapt to changes of export control laws and the risk of changes not being covered by criminalisation of assisting measures.
- Covering a wider variety of cases of proliferation financing; therefore there is a smaller risk of impairing mutual legal assistance because of lack of mutual criminalisation.

36. Other states have decided not to establish specific offences, but instead to use ancillary offences to prosecute acts of proliferation financing. This reflects a view that:

- Existing criminal prohibitions are considered as adequate; enforcement will be improved through good co-operation, bundling of information and sufficient capability and knowledge at enforcement agencies of the threat of PF.

- The key factor is that the overall legislative framework covers the essential elements (*i.e.* obligations, sanctions, means for international cooperation).

- There are not convincing reasons to establish a specific offence, either in order to meet an international obligation or to strengthen their domestic legal framework.

37. In some jurisdictions, the same conduct may also be covered by other laws, such as those related to terrorist financing and organised crime.

38. At the international level, a consistent legal approach to the criminal conduct of proliferation financing may have some advantages, including facilitating international legal cooperation and the implementation of consistent internal controls in FIs operating in several jurisdictions. However, as set out above, jurisdictions have taken several different approaches to the criminalisation of proliferation finance; and there is no prospect at this point of a standardised offence.

Policy Options for Consideration

- ***Jurisdictions should ensure proliferation financing is treated as a serious offence, and should have an adequate criminal basis within their legal systems to investigate and prosecute the conduct of proliferation finance.***

Asset Forfeiture

39. Proliferation is at least for some actors involved a crime of profit, not of ideology. Measures such as asset forfeiture, which attack the mechanisms and proceeds and instrumentalities of proliferation, are therefore an important element of the framework of legal instruments for countering proliferation financing.

40. Such powers offer the prospect of both deterring profit-driven proliferators and disrupting proliferation procurement networks by placing funds beyond their reach. Where criminal proceedings have been instituted, attention should be paid to the forfeiture of proceeds or their equivalent values and instrumentalities upon conviction. Due to the fact that often it may not be possible to institute criminal proceedings or to secure a conviction, use could also be made of civil proceedings, subject to a country's legal system, not dependant on a conviction to secure the forfeiture of instrumentalities and proceeds of crime. Restraint orders should also be obtained pending forfeiture.

Policy Options for Consideration

- ***Jurisdictions should consider whether proceeds and instrumentalities of proliferation financing acts may be subject to confiscation, on the basis set out in FATF Recommendation 3.***

Financial Investigation

41. Financial information may help as an important investigative tool and specialised financial investigative techniques can be useful in proliferation-related cases although its relevance is not yet clearly documented. As noted in the PF Typologies Report, significant amounts of data are received by FIUs currently in relation to money laundering, terrorist financing and other illicit activity, which can contribute – in some cases – to proliferation investigations even if these were not submitted in relation to proliferation activity. Financial information can in some cases be useful for uncovering proliferation activities when complemented by information held by competent authorities and other sources; linking entities of concern

together, especially given the increasing use of front companies and transhipment points by the proliferation networks in their attempts to evade export controls; and demonstrating diversion or infringement of export controls.

42. Expertise in specialised financial investigative techniques should be available to the law enforcement authorities for use in the investigation and prosecution of counter-proliferation case, as should powers to obtain documents and information for use in those investigations. In some jurisdictions, the procedures referred to in FATF Recommendations 27 and 28 have been successfully used in proliferation investigations, and in some jurisdictions, export control laws specifically include powers to obtain financial information.

Legal Protection against Criminal or Civil Liability

43. It will be important for jurisdictions to provide adequate legal protection for FIs and their directors, officers and employees (permanent and temporary) from both criminal and civil liability for breach of any restriction on disclosure of information when acting in good faith to support financial investigations into proliferation financing. This should be applicable both if jurisdictions choose to impose a duty to report suspicious transactions or if FIs report such suspicions on a voluntary basis.

Policy Options for Consideration

- ***FATF Recommendations 27 and 28, or the equivalent provisions[9], should be applied to proliferation financing.***

- ***FATF Recommendations 14, or its equivalent provisions, should be applied to proliferation financing.***

International Co-operation: Mutual Legal Assistance and Extradition

44. As set out above, jurisdictions have taken several different approaches to the criminalisation of proliferation finance; and there is no prospect at this point of a standardised offence. It is important to ensure that different approaches to criminalisation of proliferation finance do not hamper the prospects of international cooperation, through processes such as mutual legal assistance and extradition. For those forms of mutual legal assistance where dual criminality is required, the requested state (that is rendering the assistance) should have no legal or practical impediment to rendering assistance where both countries criminalise the conduct underlying the offence. Technical differences between the laws in the requesting and requested states, such as differences in the manner in which each country categorises or denominates the offence should not pose an impediment to the provision of mutual legal assistance.

45. Contrary to cases of proliferation, only one project team member has reported a successful prosecution for proliferation financing; either under a specific proliferation financing offence or through an ancillary offence related to proliferation financing. However, a further Project Team member has reported two indictments for alleged criminal activities related to proliferation financing. The Project Team has considered whether the lack of prosecutions may indicate a problem with the legal framework for proliferation financing. There is no indication that the legal prohibitions on proliferation financing are themselves inadequate. Instead, the reason is the evidential challenge involved in bringing prosecutions related to the financing of proliferation, which mean that in cases of proliferation, it is easier to secure a

[9] Since the Project Team does not want to preclude the WGTM´s decision whether existing FATF Recommendations may be applied to proliferation finance or whether new options have to be developed, we have included a reference to "equivalent provisions."

conviction for proliferation than for proliferation financing. This may be explained by the fact that to date, very few countries have a legislation in proliferation finance and that there is therefore little expertise and experience to date, with the exception of the implementation of recent UNSCRs such as UNSCR 1737, 1747 and 1803 (relating to Iran).

46. The international nature of proliferation networks, and the high degree of mobility open to their financial facilitators, have been highlighted in the PF Typologies Report. Proliferators are exploiting the uneven implementation of international obligations by locating themselves or routing funds through jurisdictions with weak export controls and/or weak implementation as well as intentionally circumventing existing export controls, which makes successful investigation and prosecution of proliferation activities challenging.

47. There is not enough experience of prosecutions resulting from cross-border investigation of proliferation, so it is impossible to make a definitive statement of the value of international legal assistance in practice. However, some jurisdictions have reported difficulty in achieving adequate international legal assistance in proliferation cases. Some jurisdictions have pointed out that some of these difficulties might stem from constitutional legal barriers. It is clear that successful investigation and prosecution will be dependent on efficient mutual legal assistance within the legal framework of each jurisdiction.

48. As set out above, jurisdictions have taken several different approaches to the criminalisation of proliferation finance; and there is no prospect at this point of a standardised offence. It can be argued that because UNSCR 1540 does not oblige UN member states to criminalise proliferation financing, it cannot be considered as imposing an obligation on states to enable mutual legal assistance in the area of proliferation finance.

Policy Options for Consideration

- ***To avoid safe havens for proliferators or their facilitators, it is essential to ensure that jurisdictions have procedures in place to render mutual legal assistance in support of the investigation and prosecution of offences of proliferation financing and where possible, extradite individuals charged with such offences. FATF Recommendations 36, 37, 38, 39, and 40, or their equivalents, appear relevant to proliferation financing.***

- ***The FATF could consider undertaking further analysis to determine whether different approaches to criminalisation of proliferation financing impact the prospects of international cooperation in the view to investigate and prosecute proliferation financing.***

Export Control Systems

49. The obligations set out above do not amount to a complete framework of international legal obligations in relation to proliferation financing: Consistent international implementation of export controls is a prerequisite for effective proliferation finance measures. However, not all countries have or implement export controls. Some countries have legal prohibitions on proliferation, but do not have an export licensing or law enforcement authority with the responsibility and capability to enforce those prohibitions, making it more difficult for those countries to comply with their obligation, pursuant to UNSCR 1540, to establish, develop, review and maintain appropriate effective national export and trans-shipment controls. ***The FATF should note that adherence to the guidelines and the control lists developed by major producers in the export control system would increase the effectiveness of counter-proliferation efforts globally***.

IV. Targeted Financial Sanctions

50. Targeted financial sanctions[10] can be a positive and effective measure in disrupting WMD proliferation networks. They act not only as a disruptive tool but as a way to provide FIs with proliferation-related information on which they can take action. The disruptive impact of targeted financial sanctions is considered to be most effective when they are implemented globally *i.e.* by the UN, since the designated entity cannot as easily turn to third-country FIs to evade sanctions. Hence, the UN, as the body responsible for UNSCR 1540 and for ensuring the adoption of effective measures for the worldwide implementation of this Resolution, also has a role in considering the benefits of targeted financial sanctions as a possible avenue for meeting finance-related obligations under UNSCR 1540.

51. Some jurisdictions, including the United States, 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. A more detailed discussion on the use of targeted financial sanctions in the context of counter-proliferation efforts is attached to this report as Annex 2.

UNSCR 1540 and Targeted Financial Sanctions

52. The general obligation on states is to prevent the activities that UNSCR 1540 describes. UNSCR 1540 does not specifically require states to establish an asset freezing regime. Nevertheless, some jurisdictions have implemented national targeted financial sanctions as a route to meet finance-related obligations under UNSCR 1540. However, UNSCR 1540 primarily requires implementation of export controls; thus no jurisdiction can rely on sanctions alone to meet these obligations.

Value of Targeted Financial Sanctions in Counter-Proliferation Efforts

53. Although research in this area is limited, Annex 2 notes some characteristics of WMD proliferation financing that make targeted financial sanctions particularly effective in addressing proliferation, such as WMD proliferation networks' abuse of the formal financial sector to carry out proliferation-related transactions. Furthermore, the fact that some elements of the proliferation support network may operate for financial gain may make them more susceptible to deterrence by measures that publicly expose them, alerting financial and commercial sectors that they are involved in proliferation activity.

54. 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. On the other hand, this may also create particular challenges as it may also make it more difficult for competent authorities to trace and detect proliferation activities.

Ability of Financial Institutions to Implement Targeted Financial Sanctions

55. Discussions with private sector experts have highlighted the advantages of list-based financial sanctions as a counter-proliferation finance tool from the perspective of FIs. The principal responsibility placed on FIs by targeted financial sanctions is to verify the identity of their customer or counterparty. Therefore entity-based targeted financial sanctions can be implemented effectively by FIs through their use

[10] For the purposes of this report, "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.

of existing screening systems. Moreover, sanctions lists are an actionable form of information, on the basis of which an FI may freeze an account or refuse a transaction, as required by legislation, involving a listed person or entity without the risk of legal challenge. The quality of lists, intelligence co-operation between jurisdictions, and the effectiveness of de-listing processes following corrective action, have all been identified as important factors in effective use of sanctions.

Targeted Financial Sanctions as a Supplement to Export Control Regimes

56. As discussed above, effective export controls are critical for implementation of UNSCR 1540. Targeted financial sanctions can be a supplement to export control regimes, as export control may not adequately disrupt the financial activities of specific individuals and entities involved in WMD proliferation. While those involved in the illegal export of sensitive proliferation-related items may be prosecuted and convicted under these regimes, there may be factual obstacles, *e.g.* the end-user will typically be in a different jurisdiction which might hamper prosecution. Experience with targeted financial sanctions in other contexts indicates that targeted financial sanctions may provide an avenue to address these difficulties in a counter-proliferation regime, given that they allow for the disruption of a wide range of actors in a proliferation network.

Implementation of Targeted Financial Sanctions Against Proliferation Finance

57. Existing FATF guidance on targeted financial sanctions, including the FATF's Best Practices Paper on Special Recommendation III [11], is relevant for the implementation of targeted financial sanctions in the counter-proliferation context. In particular, it is critical to ensure there is an adequate process for judicial review, listing, and other due process concerns in the implementation of any targeted financial sanction program.

58. The FATF guidance on implementing the financial provisions of UNSCR 1737, including freezing the assets of an FI also provides valuable advice to assist jurisdictions in implementing targeted financial sanctions imposed multilaterally against proliferation threats. To expand the options available, jurisdictions may also consider their own capability to apply targeted financial sanctions as one possible means to implement the financial obligations of UNSCR 1540.

59. However, recent legal challenges faced before national and/or regional courts to asset freezing decisions show the high level of impact that such judicial oversight can have on targeted financial sanctions regimes, and the challenge this can pose to implementation. Aside from legal considerations, effective practical implementation of UNSCR 1373 under Special Recommendation III (SR. III) remains a challenge for some jurisdictions. For example, as noted in the SR. III Best Practices Paper, key information supporting the designation of an individual or entity may often be intelligence sourced. In this perspective, good targeting – with adequate due process protections and the ability to use intelligence appropriately – can be difficult for some states. Further challenges may include the fact that targeted entities may change their name and thereby escape screening by FIs.

Policy Options for Consideration

- ***As part of a comprehensive framework of safeguards and controls on proliferation and proliferation financing, jurisdictions should consider establishing regimes for applying preventative targeted financial sanctions to individuals and entities involved in proliferation.***

[11] http://www.fatf-gafi.org/dataoecd/30/43/34242709.pdf

- ***The FATF should evaluate how FATF members have used targeted financial sanctions and consider whether and how the use of targeted financial sanctions against proliferation finance can be incorporated into the FATF's existing standards on targeted financial sanctions.***

V. Responsibilities of Financial Institutions

60. Vigilance exercised by FIs over the activities of their customers is the fundamental element of the framework of measures against money laundering and terrorist financing. Such vigilance also has an important role in countering proliferation financing. The PF Typologies Report noted that all FIs involved in trade finance, no matter what their business line, have both commercial incentives and legal obligations to conduct Customer Due Diligence (CDD) and potentially account monitoring. But the nature and depth of CDD undertaken, and how it is organized, can vary significantly between FIs and from transaction to transaction and based on the FI's risk profile as well as regulations of the local jurisdiction.

61. The Project Team has considered the responsibilities FIs should have in relation to proliferation financing. This includes whether they should be required to undertake risk assessment and CDD, and how the requirements for proliferation financing may differ from existing anti-money laundering (AML)/counter-terrorist financing (CFT) requirements, for example in the supporting information required, the relevant sectors and roles, and the appropriate responsibility for non-financial bodies.

62. As set out in Section II above, there are a number of risks in making FIs responsible for vigilance against proliferation financing. These include the risk of duplication in the interactions between financial and export controls; of disproportionate impact on exporters and legitimate but higher-risk customers; and of diverting export control authorities to providing assurances with respect to low-risk transactions. These have a potentially serious impact on the efficiency of the financial system and the effectiveness of export controls. It is therefore important that the responsibilities of FIs are set carefully and clearly, and with regard to the specific role of the FI.

63. The Project Team has considered text on *Applying the Risk-Based Approach to Proliferation Financing*, which is attached to this report as Annex 3. That text considers how the risk-based approach could be applied to proliferation financing, and specifically the respects in which it would differ from the risk-based approach as applied to money laundering and terrorist financing. It also takes into account the export control systems that already exist concerning the underlying transactions. The purpose of this approach is to ensure that FIs understand the proliferation financing risks they face and ensure they have the appropriate policies, procedures and processes in place to manage such risks.

64. There is further need to improve the clarity and implementation of the risk based approach to proliferation in many areas. However, the greatest opportunity for intervention and enhanced due diligence is in instances where there may be direct banker/compliance engagement *i.e.* large structured or complex transactions which may require specific authorisation according to internal procedures. Ongoing risk-based transaction monitoring would also benefit from access to information regarding the types of indicators (if available and feasible), beyond entities of concern, which may be applicable to proliferation financing.

65. On the basis of the considerations set out in Annex 3, the Project Team has converged on a number of policy options which the WGTM could apply with regard to the responsibilities of FIs:

- ***Jurisdictions should encourage FIs to incorporate the risk of proliferation financing as part of their established preventive measures and internal controls; with respect to clear and consistent criteria, where appropriate, and in accordance with implementation, to the extent possible, of a risk-based approach.*** This assessment should be integrated with current CDD and risk analysis frameworks. The provision of criteria/indicators, guidance, and other relevant

information by national competent authorities, whenever possible, would contribute to enhancing the quality and relevance of the risk assessment and effectiveness of preventative measures. ***The WGTM should undertake to further analyse the risk-based approach to proliferation financing, in collaboration with the private sector.***

- ***Further analysis should be undertaken by the FATF to determine whether and how the FATF Recommendations dealing with CDD (Recommendations 5–9), and with FIs' internal controls (Recommendations 15 & 22), or their equivalents, could be applied to proliferation financing.*** This should be developed in collaboration with the private sector and the competent authorities, *e.g.* export control authorities and supervisors. Likewise, enhanced cooperation between the competent authorities in charge of monitoring FIs/financial information and those in charge of counter proliferation should be promoted. Regular consultations could lead to national improvements in risk analysis that would benefit to the private sector.

VI. Channels for Receiving Information from Financial Institutions, including Reporting

66. The flow of information between governments and FIs is a central theme in countering proliferation financing. Information held by FIs is potentially beneficial to jurisdictions' counter-proliferation investigations. The Project Team has considered what information held by FIs is most relevant to proliferation financing; how it could supplement existing information; how FIs could identify proliferation financing; and how this information could be made available to competent authorities. This has focused on the questions of whether FIs should be obliged to provide information through suspicious transaction reports (STRs) or other mechanisms, and what form of internal controls should be implemented within an FI in order to identify activity which may be related to proliferation.

67. It is important to distinguish the question of what level of vigilance FIs should be expected to exercise; and of what action they should take when they do identify suspicious activity. As the paper *Applying the Risk-Based Approach to Proliferation Financing* sets out, the right or obligation to report suspicious activity may be considered as one element of the overall framework for risk assessment and management. The PF Typologies Report indicates there are several points in the trade finance cycle at which FIs could potentially detect suspicious activity, if provided sufficient information. If suspicious activity is suspected, the role of FIs is not to determine the underlying criminal activity, but can be to report suspicious activity if obliged by their domestic legal framework and relevant local regulations. Managing of expectations both on the public sector and the private sector is crucial.

68. In response to the survey conducted for the PF Typologies Report, jurisdictions generally reported that financial information could add to the existing export control regimes to counter proliferation and proliferation financing and provide useful information to ongoing investigations. Some Project Team members also noted the historical value of the information contained in STRs as being important for the identification of additional suspect individuals, businesses, and accounts which might otherwise never be known to law enforcement. Therefore, whilst a report filed by an FI may not appear to have any investigative relevance at the date of its filing, it may become relevant to an investigation in the future. In general, the types of financial information useful to help detect diversion included information on persons involved in transactions in any associated letter of credit; including specific information on parties to the transaction. Information held by the FI on persons or entities involved is potentially relevant, including identifier and contact information about customers and counterparties.

Transaction Screening

69. There are several measures which can be implemented by FIs to mitigate the risk posed by high-risk customers, including enhanced due diligence, increased monitoring, enhanced frequency of

relationship reviews and senior management approval. Alongside these measures and controls, FIs use automatic systems to assist with the identification of sanctioned entities, and suspicious patterns of account activity relating to money laundering and terrorist financing. The Project Team has considered whether and how such systems could be applied in relation to proliferation finance.

70. As noted in Section IV above, FIs have a strong preference for entity-based financial sanctions as a counter-proliferation finance tool, because they can be implemented effectively in FIs using existing automatic systems and are actionable. The ability of FIs to implement activity-based controls against proliferation is limited, due to the lack of technical expertise of banks, the limited information available as a basis for such controls and FIs' 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 FIs' visibility of the whole transaction.

71. Real-time screening against lists of entity-names is already normal practise in many FIs in order to meet their obligations with regard to financial sanctions, and has demonstrated its value as a means of preventing entities known to be involved in proliferation from openly using the formal financial system.

72. Where lists of entities are available, FIs' programmes against proliferation financing should consider the appropriateness of undertaking real-time screening of transactions. Lists of entities in this context could potentially include both entities subject to targeted financial sanctions *i.e.* UNSCR 1737, with which transactions are prohibited; and, 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 practices if obliged by national legislation. Some members have raised the concern that FIs tend to treat all types of lists as financial sanctions lists hence running the risk of altogether prohibiting business with these entities and jurisdictions. Jurisdictions which issue such lists should accompany them with clear guidance on their status and the basis on which entities are included, to ensure FIs do not use them in the same manner as sanctions lists. Other members have pointed out that in some countries the use of commercially available lists of sanctioned entities is already common within the private sector and banks have implemented appropriate risk-based policies and procedures to facilitate business decisions regarding the acceptance and continuation of customer relationships.

73. Goods based screening; the evaluation of whether goods are involved in a transaction 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 definitely a greater one for real time screening than entity lists. Furthermore, FIs 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 by FIs, as they are difficult for those without a degree of technical expertise to interpret correctly which thus make them an inefficient safeguard.***

Account Monitoring

74. Real-time screening against listed entity-names has limitations, and may be evaded if the listed entity changes its name or operates through an un-listed front company. Alternative approaches would be required to identify and prevent proliferation financing activity conducted by un-listed entities. These could include both the manual systems noted above – enhanced due diligence, increased monitoring, and enhanced frequency of relationship reviews – and automatic systems such as post-event monitoring of account activity. However this also requires guidance to the banks on which entities to look for. Otherwise screening obligations would result in bureaucratic, ineffective and disproportionate procedures. Post event monitoring, using multiple risk indicators, may have the potential to identify proliferation financing

activity, but further work is needed to assess what its potential is; identify the knowledge and information requirements for it to be used effectively, and to develop the indicators of suspicious activity which would be needed.

Policy Options for Consideration:

- ***FATF should conduct further analysis, in collaboration with the private sector, on the types of information and guidance jurisdictions should provide to FIs to assist them in monitoring for proliferation financing activity.***

Suspicious Transaction Reporting and Other Forms of Reporting

75. Suspicious transaction reporting on proliferation financing is undertaken by FIs in some jurisdictions, including in the United States and the European Union (EU). In the EU, regulations oblige FIs to report suspicious transactions in relation to Iran's and North Korea's non civil proliferation programmes[12]. In Europe the reports are therefore limited to the reporting of transactions in relation to one country. There does not exist a general suspicion of proliferation financing reporting requirement. In some cases these have been received by FIUs, in other cases FIUs only act as a postal box for other governmental agencies, such as customs or intelligence services. Some export control authorities reported that they receive inquiries from FIs regarding WMD-related suspicious transactions. FIs in the United States that identify activity that is suspicious, unusual or lacking a legitimate purpose are required to file suspicious activity reports. Such activity could include violations of sanctions law and export control laws. For example, the Financial Crimes Enforcement Network (FinCEN), the financial intelligence unit for the United States, conducted an analytical study of STRs identified as containing information potentially relevant to the proliferation of WMD[13].

76. For most jurisdictions, the number of reports submitted on the basis of proliferation is low. Substantial analysis of STRs related to proliferation has been limited, so at this stage it is not possible to reach definite conclusions about their value. According to some members of the Project Team, particularly in cases related to country specific sanctions, the reports received through this route have been relevant to counter-proliferation investigations; and the wider pool of STRs which did not identify proliferation financing as the basis for suspicion, can include information related to entities of interest to counter-proliferation investigators. Other project team members mentioned the experience that the imposition of reporting requirements and targeted financial sanctions led to proliferation payments being made outside

[12] EU Regulation 423/2007 (amended by Reg. 1110/2008) requires financial vigilance in relation to Iran. Regulation 329/2007 (amended by Reg. 1283/2009) introduces similar provisions in relation to North Korea.

[13] FinCEN analysed general suspicious activity reports (SARs) filed by depository institutions between January 1, 2004 and December 31, 2008. FinCEN examined these SARs with the purpose of identifying possible indicators of suspicious activity pertaining to WMD proliferation reported in the narrative sections of the SARs. The analysis reveals that 90.3 percent of the SAR narratives reviewed did not reference Office of Foreign Assets Control (OFAC)'s Specially Designated Nationals and Blocked Persons List. Of the reviewed SARs, 81 percent mentioned the use of external and/or open source request and/or information. For less than 5 percent of the SARs studied various indicators of suspicious activity reported in the narratives involved events or circumstances where a Letter of Credit (L/C) customer or other party to the L/C: changed one of the key terms of condition of the L/C at the last moment, requested multiple L/Cs to perform a transaction that could be accomplished with one, the price of the underlying product did not reflect market rates, or the supplier of the product was not known to be a supplier or trade in the high quantity ordered. While FinCEN analyzed the suspicious activity reported in the SARs, FinCEN could not determine the full decision-making process that financial institutions followed in filing the SARs.

the formal financial sector, which has led to difficulties for customs and other law enforcement agencies in conducting investigations of export controls.

77. In comparison the experience of a number of one other member of the Project Team indicated that reports received led to very few inquiries for violations of sanctions and that there was no case in which the suspicion was confirmed. One reason for this may be the fact that violations of the sanctions regime constitute a crime in that member's jurisdiction and FIs would strive to prevent violations. Moreover, in this jurisdiction, authorities may review and monitor the records of banks and companies involved in foreign trade for violations of export controls or sanctions at any time without suspicion of a violation of export controls or sanctions. As a consequence, exporters and FIs have a strong incentive not to violate export control provisions.

78. Automatic reporting of transactions (*e.g.* based on monetary threshold or country) by FIs is required by a few jurisdictions. It should be noted that such automatic reporting is very specific to certain countries and dependent on the structure chosen by different FIUs. The view taken by some members of the Project Team is that the automatic reporting of transactions would lead to a disproportionate amount of reports that could not be examined by enforcement or export control authorities and would therefore not ensure that authorities would detect relevant transactions.

- However in one Project Team member, Canada, the FIU (FINTRAC) receives international electronic funds transfer reports (EFTRs) involving $CAN 10,000 or more. Given the high volume of reports, FINTRAC is not examining all EFTRs. Such threshold reports are used in conjunction with STRs, other types of reports and voluntary information provided by, for example, law enforcement authorities. A sophisticated IT system allows FINTRAC to extract EFTRs that are relevant to a specific case. In most cases developed by FINTRAC relating to proliferation activities there tended to be a very large number of EFTRs. Canada believes that using FINTRAC as a central body to receive all reports provides the opportunity to add value to a case by analyzing all types of reports together and allowing linking new incoming reports with other reports available in FINTRAC's data holdings. Once a case is completed, using various sources of information, it can be disseminated by FINTRAC to appropriate authorities.

The Role of the Competent Authorities

79. Some FIUs already serve as the national centre for receiving reports of proliferation financing. However, in other jurisdictions, the FIU is not the competent authority for reports on proliferation. In many countries, there has been an institutional separation between the competent authorities responsible for investigating money laundering and terrorist financing, and those responsible for investigating proliferation and proliferation finance.

80. In jurisdictions where competences for investigations of proliferation finance and proliferation are split, there is also a need at a practical level to ensure that knowledge and expertise is communicated – in both directions – between authorities responsible for financial investigation and counter-proliferation, for example through training for financial investigators. The security perspective of intelligence agencies is the most relevant to counter-proliferation investigations, and jurisdictions should make financial information available to export control enforcement agencies and intelligence services.

Policy Options for Consideration

- ***Recommendation 31, or equivalent provisions, should be applied to proliferation financing.***

- ***Jurisdictions should consider whether and how suspicious and/or other transaction reporting mechanisms could be applied to proliferation financing.***

VII. Awareness and Information Sharing by Jurisdictions

81. Increased awareness and effective information sharing are critical in enabling FIs to address proliferation financing risks. Effective implementation by FIs of safeguards against proliferation financing depends on the availability of information on proliferation risks, including possible generic indicators and specific information on entities of concern. Awareness and generic information is the foundation for implementing a risk based approach to proliferation in the private sector. Specific information regarding entities or singular shipments of concern is the basis for the screening, monitoring, and possible reporting of customers or transactions. The Project Team has undertaken a preliminary review of:

- The options for establishing awareness of proliferation financing and the availability of training, possible typologies, indicators, or similar information.

- The types of specific information which could be made available to the financial sector, and the potential utility of such information for the purposes of screening and monitoring.

- The manner in which such information could be shared with the private sector.

- The Project Team has sought to identify current practises in these areas which are highlighted below.

82. Awareness raising and information sharing mechanisms within governments are also required, to enable effective cooperation between government agencies concerned with proliferation and those concerned with proliferation finance (which may be identical with the agency concerned with money laundering and terrorist financing), which is emerging as a critical element of effective safeguards against proliferation financing. Given the international dimension of proliferation financing, effective mechanisms to share information between governments is also crucial. Within the framework of the different export control regimes, general information on sensitive goods and sensitive regions is exchanged as well as specific information on licences denied. This information sharing is of crucial importance for the functioning of these regimes.

Awareness and Outreach

83. The PF Typologies Report identified that outreach by government on proliferation risks is critical. While outreach to export sectors exposed to proliferation risks already takes place to a high degree in many countries, outreach to the financial sector does not take place to the same degree. Awareness of proliferation financing risks within the financial sector appears to be low in countries which do not have a sophisticated export control system.

84. Discussion with private sector experts has indicated a rising level of awareness of proliferation financing. However, in some countries increased awareness seems to be concentrated among anti-money laundering and compliance specialists in major international banks in the financial sector while awareness of proliferation finance risks seems more limited among small- and medium-sized FIs.

85. Outreach conducted by export control authorities to industries includes the production of guidance and background information; programmes of company visits or training. Some export control authorities also provide information to exporters via export associations, to increase the awareness of exporters and FIs when being approached by potential clients. Experience shows that these activities increase the exporters´ knowledge of export controls and decrease the hurdle of contacting the authorities in cases of doubt, *e.g.* to clarify whether goods are subject to licence requirements or the end–user involved is critical or not.

- The German Federal Office of Economics and Export Control (BAFA) conducts, among others, information seminars, participation in training workshops, company visits and the production of written guidance regarding export controls. Furthermore, information available to anybody interested in export controls (*i.e.* exporters and FIs), is published and regularly updated on the websites of most export control authorities, as well as information leaflets.

- Dutch industry is informed of changes in legislation and relevant developments in foreign policy (*e.g.* sanctions and embargoes) through a regular e-mail newsletter that is distributed in cooperation with organised interested parties. In addition, the Finance Ministry and the Dutch Central bank join the monthly sanctions working group of the Dutch Bankers association, in order to clarify legislation, and discuss wider questions such as how to efficiently process authorisation requests. Both the Ministry of Finance and Central Bank, have formal contact points for questions on proliferation financing and financial sanctions.

86. Some jurisdictions do conduct outreach to the financial sector on proliferation financing, or open their proliferation-related awareness activities to participants from FIs, but this is not as widespread, and may not be supported by the same level of background information or training provision, as is provided to exporters. ***Jurisdictions should conduct outreach to the financial sector regarding proliferation financing, and incorporate a financial element within outreach to exporters.*** Outreach programmes to the exporting industry may also benefit from expansion to include awareness of proliferation financing and, if available, indicators of proliferation financing.

87. Background information on proliferation financing which can be made publicly available is important to enabling FIs to develop models for assessing and mitigating risk. Such information, where available and legal under national legislation, may include case studies; outcomes of legal proceedings; and, if available, typologies and risk indicators.

88. The limited information publicly available on proliferation financing reflects the limited base of source material, due to the small number of proliferation finance-related prosecutions which have been undertaken. Future prosecutions will add to the information available. This can be supplemented using information derived from STRs, if available.

Policy Options for Consideration

- ***Jurisdictions should conduct outreach to the financial sector regarding proliferation financing, and incorporate a financial element within outreach to exporters.***

- ***Jurisdictions should consider disseminating more widely the outcomes of legal proceedings relevant to proliferation financing, subject to their national legal systems.***

- ***Jurisdictions should further examine possible typologies of proliferation financing and strive to identify further risk indicators.***

Types of Specific Information

89. The previous chapter sets out the role of automatic systems in the context of a risk-based approach to proliferation financing. Transaction screening in real-time, and account monitoring post-event, could be important elements of FIs' controls for managing proliferation finance risks. These automatic systems can operate only on the basis of good-quality, actionable information which can enable systems to flag genuinely high-risk transactions. Several types of information are held by jurisdictions which could potentially be used as a basis for conducting automatic screening or monitoring.

90. *Lists of controlled goods* are the basis for export control regimes. However, export control lists have significant disadvantages as a basis for vigilance by FIs. Financial experts have emphasised to the Project Team the limited information visible to an FI about the goods associated with any given financial transaction: An open account transaction will not include any information at all about the goods. A letter of credit might include some information, but the FI cannot verify whether the goods are as described; and the description of the goods will not normally include sufficient technical information to determine whether the goods are subject to export controls. FIs lack the technical expertise needed to make use of such information. The length of export control lists, and the high likelihood of false matches, make them an impractical basis for automated screening by FIs. Finally, export control lists are already the basis for counter-proliferation safeguards by exporters and export control organisations. ***Jurisdictions need not encourage FIs to screen transactions on the basis of lists of controlled goods.***

91. Though lists of controlled goods are not a practical basis for FIs to screen transactions, some countries do see specific circumstances when they maybe relevant; for example when there is an urgent operational need to identify the transfer of the most highly sensitive goods. In such circumstances, there may be value in targeted screening for a specific high-risk good. Some members of the Project Team have reported instances where an FI detected a suspicious activity based upon the type of good involved in the transaction. There may be circumstances where governments would be able to provide enough adequate information about a specific good sought by proliferators for FIs to detect and report transactions involving that good.

92. *Lists of Sanctioned Entities*, including those subject to targeted financial sanctions by the UN or jurisdictions on a national or supra-national basis, are already used effectively by FIs to screen their customer base and transactions, in order to comply with obligations under sanctions regimes. FIs have noted that FIs have the information; capacity; and knowledge to make use of lists of entities, individuals or companies, and highlighted that sanctions lists are actionable: an entity's inclusion on a sanctions list is sufficient ground to refuse to do business with it.

93. *Advisory-lists*, naming entities of proliferation concern, are available from some jurisdictions. Such lists are entity-based, as with lists of sanctioned entities, and so can be used easily within existing screening systems. But they list entities which are not subject to financial sanctions, and so may not justify an FI to refuse to execute a transaction, since they indicate elevated risk, and not a prohibition on conducting business[14]. Finding a match with an entity on a advisory-list would not obligate an FI to suspend or refuse the transaction, but could prompt reporting to the competent authorities, or conducting additional due diligence, according to a risk-based approach. FIs have indicated that names of entities with WMD-related concern will to some extent be useful; but pose greater practical and legal difficulties than sanctions lists. Jurisdictions which issue such lists should accompany them with clear guidance on their status and the basis on which entities are included, to ensure FIs do not use them in the same manner as sanctions lists.

[14] In some jurisdictions, an entity included in advisory lists may also appear in sanctions lists.

94. There are several bases for compiling such lists, for example they could list end users for which an export license has been refused, or be a "watchlist" of entities of concern to export control authorities. Though some lists are available already nationally, including some to the public and others only on a confidential basis, the feasibility of this approach in general and the conditions under which such lists could be shared with FIs remains to be looked at in-depth, including the potential for reputational and diplomatic problems; for example, the reputational and economic consequences to listed entities could lead to liability action against the disseminating authorities. In addition, the publication of listed foreign entities may cause diplomatic protests by their home governments.

Policy option for Consideration:

- ***Jurisdictions should consider making available lists of entities of proliferation concern, as a basis for screening by FIs, to the extent possible, in the context of a risk-based approach and with respect to their legal framework. Jurisdictions which issue such lists should accompany them with clear guidance on their status and the basis on which entities are included, to ensure FIs do not use them in the same manner as sanctions lists.***

95. Assessments of country risk include information on countries of proliferation concern; and on commonly used diversion routes or economic zones with weak export controls. Country risk is an essential element of FIs' risk models in relation to money laundering and terrorist financing, and FIs already make use of publicly available information on these risks, including reports by the International Financial Institutions and the FATF. However, governments' evaluation of country risks of proliferation is normally reflected only in sanctions against countries of proliferation concern and in export licence requirements, and neither of these provides FIs with graduated information about country risks. Governments do not in general identify countries of proliferation concern or assess other jurisdictions' export controls or measures to counter-proliferation financing. In the absence of such information FIs will not be in a position to make an informed assessment and therefore will not be in a position to utilise this indicator.

Mechanisms for Sharing Information

96. Information on proliferation financing entities and risks is most useful to FIs when it is in the public domain, and is actionable. The actionability of information ensures that an FI is in a position to refuse a transaction or customer, and if the information is public, it can disclose its reasons for doing so. Targeted financial sanctions place information about proliferation-linked entities in the public domain in an actionable form.

97. It is more difficult, and more risky, for an FI to use information which is either not actionable, or not public. However, there are significant challenges for jurisdictions in making information available in a public or actionable form. The most critical risk is to the sensitivity of the information itself. The risk of legal challenge can also be significant, *e.g.* by companies which lose business because they are listed as proliferation concerns.

98. Specific information about proliferation risks and entities is highly sensitive. When deciding whether to make such information available to the private sector, competent authorities judge whether the value of disclosure, (*e.g.* in disrupting a proliferation front-company by adding it to a watch-list); outweighs the risk of exposing the information, (*e.g.* when the front company changes its name in response to listing). The most sensitive information cannot be shared with the private sector at all, while sharing less sensitive information may be considered on a case-by-case basis. There are a number of channels through which jurisdictions can engage with FIs about proliferation which reduce the risk of publicising sensitive information.

99. *Targeted information* may be given to an FI by the authorities to alert it to the activities of a particular customer. Such information will often be passed only to the FI directly involved with the customer. The targeted nature of such alerts helps protect the information. Such targeted mechanisms do not mean information is shared informally: formal processes and controls can be used to ensure information is actionable; that it does not expose either government or the FI to legal risk; and that it does not give any competitive advantage.

100. *Restricted / Security-vetted contact groups* are used by some FIUs and other authorities as fora for discussion of money laundering and terrorist financing. These examples may be applicable in the context of proliferation financing:

- FinCEN holds meetings with industry representatives regarding sensitive information received through analysis of suspicious activity reports submitted to the FIU or through discussions with law enforcement. Generally, industry participants have submitted some of the information being analysed or are geographically or topically related to the subject to be discussed. These meetings are held periodically, when industry may be able to provide additional or future information. All participants must have appropriate security clearance and are informed of their limited ability to distribute any information discussed. These meetings are separate and apart from the regularly scheduled discussions through the Bank Secrecy Act Advisory Group (BSAAG) meetings, which gather law enforcement, regulators and industry representatives for discussions on the ways in which the AML/CFT reporting requirements could be modified or improved to enhance the ability of law enforcement agencies to use the information. The BSAAG discussions also assist in informing private sector representatives of law enforcement's uses of the referenced reports and STRs provided by FIs. BSAAG discussions are non-public, but members do not need restricted clearance. FinCEN also meets regularly with individual FIs through a dedicated outreach initiative, which is another avenue for open and non-public discussions about where requirements may benefits from further clarification.

- In the UK, the Financial Intelligence Unit has created a similar group that comprises security-cleared representatives of the reporting sectors, of law enforcement and of the key policy departments. Its aims are to discuss sensitive casework and reporting issues, and to clear the distribution of guidance by the FIU to the sector as a whole.

101. *Limited distribution alert*s are issued by both FIUs and export control authorities and could be useful in gathering additional information for investigations of proliferation cases:

- In the German export control system there are different ways to alert the industry to specific proliferation risks. *Early warning lists* are regularly released to the industry containing information about countries carrying out WMD programmes and names of front companies involved in procurement activities. These lists constitute an offer to the industry and are not considered as black-lists. Since the information is confidential and for internal use only, the alerts are distributed to the export industry via chambers of commerce and trade associations. Another information mechanism, according to the EC-regulations applicable in all EU Member States allows for a *written notification* to individual exporters in concrete export cases if the goods are intended for a sensitive proliferation-relevant end-use. Sending such information to the exporter constitutes a licensing requirement in the concrete case. Thus the exporter is obliged to file an export application ("catch-all-controls"). Furthermore, government authorities may also alert companies informally in individual cases about potential proliferation attempts without constituting a licensing requirement. Moreover, all industry outreach activities (cf. par. 81) raise the awareness of exporters about proliferation risks.

- In the United States, Section 314(a) of the USA PATRIOT Act of 2001 authorizes information sharing between Federal law enforcement agencies and financial institutions. Under the Section 314(a) a Federal law enforcement agency investigating terrorist activity or money laundering may request that FinCEN solicit, on the investigating agency's behalf, certain information from a financial institution or a group of financial institutions. Such a mechanism may be beneficial in the context of proliferation financing since it may provide law enforcement with the ability to vet suspect names through FIs in a secure manner and receive a timely response.

102. Information sharing between FIs can also be useful in this context:

- In the United States, Section 314(b) of the USA PATRIOT Act provides safe harbour for certain FIs to share information with one another for the purpose of helping to identify and, report, as appropriate, possible money laundering or terrorist financing activity. The safe harbour protection available to FIs that choose to share information requires that they submit a yearly certification to FinCEN stating that the information to be shared will be protected from inappropriate disclosure, and that any money laundering or terrorist activities uncovered will be reported to FinCEN or a law enforcement agency. Participation in the 314(b) information sharing is voluntary, but banks, certain money services businesses, broker/dealers, and certain other FIs eligible for the safe harbour provision are encouraged to consider how voluntarily sharing information can help to facilitate suspicious activity monitoring.

Policy Option for Consideration:

- ***Jurisdictions should consider developing restricted forums and distribution mechanisms which could be used, when appropriate, to share relevant information with FIs.***

103. In addition to the information available directly from jurisdictions, FIs also make use of information aggregated and compiled by private companies. Databases are available commercially which include sanctions and risk information from a number of national authorities and other sources in a common, screenable format. Such information does have some value for FIs, but is not a substitute for advice from governments and must not lead to the expectation that FIs evaluate risk apart from that emanating from sanctions in force without government guidance.

Information-sharing & Co-operation within Governments

104. Coordination among all relevant authorities for proliferation and proliferation financing including export control authorities, customs and intelligence are key to an effective prevention of proliferation finance. Effective proliferation finance safeguards require a coherent approach across government, which means connecting the two systems-including establishing mechanisms to raise awareness, and through which specific information relevant to investigations can be passed between the different competent authorities for proliferation finance crime and counter-proliferation investigations.

- In Switzerland, the different agencies concerned with proliferation and export controls exchange information on a regular and on a case-by-case basis. Awareness raising is undertaken with industry associations and individual companies. Requests for export licences for sensitive destinations or involving sensitive goods are treated in an inter-ministerial body.

- The Netherlands has established an interagency and interdepartmental forum, the "Carré-consultation" which includes Foreign Affairs, Finance, intelligence service, export control authorities, law enforcement agencies and the licensing authority; and discusses existing and

future policy on export controls, and enforcement issues, both in relation to actual cases, licensing requests and follow up enforcement.

105. Jurisdictions should ensure there are no legal obstacles to operational information exchange between competent authorities responsible for export controls and for proliferation finance investigations. Recommendation 31, or its equivalent, is relevant here. Recommendations 26 (FIU or other competent authority), 27, 28 (requirement to obtain financial documents), 29, 30 (adequate financial, human and technical resources), or their equivalents, could also be applied to proliferation financing.

Policy Option for Consideration:

- ***The FATF could consider undertaking further work to identify best practises in the area of information-sharing.***

VIII. Summary of Policy Options for Consideration

106. The Project Team suggests the following policy options for consideration by the WGTM. Since the Project Team does not want to preclude the WGTM's decision whether existing FATF Recommendations may be applied to proliferation financing or whether new options have to be developed, we have included a reference to "equivalent provisions" when referring to existing FATF Recommendations and Special Recommendations:

- ***Option 1: The FATF should consider this provisional definition as a basis for further work on proliferation financing:***

  Proliferation financing refers to:

  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.

Legal Systems

- ***Option 2: Jurisdictions should ensure proliferation financing is treated as a serious offence, and should have an adequate criminal basis within their legal systems to investigate and prosecute the conduct of proliferation finance.***

- ***Option 3: Jurisdictions should consider whether proceeds and instrumentalities of proliferation financing acts may be subject to confiscation, on the basis set out in FATF Recommendation 3.***

- ***Option 4: FATF Recommendations 27 and 28, or the equivalent provisions, should be applied to proliferation financing.***

- ***Option 5: FATF Recommendation 14, or equivalent provisions, should be applied to proliferation financing.***

- ***Option 6: To avoid safe havens for proliferators or their facilitators, it is essential to ensure that jurisdictions have procedures in place to render mutual legal assistance in support of the investigation and prosecution and where possible, extradite individuals charged with such offences. FATF Recommendations 36, 37, 38, 39, and 40, or their equivalents, appear relevant to proliferation financing.***

- ***Option 7: The FATF could consider undertaking further analysis to determine whether different approaches to criminalisation of proliferation financing do not hamper the prospects of international cooperation in the view to investigate and prosecute proliferation financing.***

- ***Option 8: The FATF should note that adherence to the guidelines and the control lists developed by major producers in the export control system would increase the effectiveness of counter-proliferation efforts globally.***

Targeted Financial Sanctions

- ***Option 9: As part of a comprehensive framework of safeguards and controls on proliferation and proliferation financing, jurisdictions should consider establishing regimes for applying preventative targeted financial sanctions to individuals and entities involved in proliferation.***

- ***Option 10: The FATF should evaluate how FATF members have used targeted financial sanctions and consider whether and how the use of targeted financial sanctions against proliferation finance can be incorporated into the FATF's existing standards on targeted financial sanctions.***

Responsibilities of Financial Institutions

- ***Option 11: Jurisdictions should encourage FIs to incorporate the risk of proliferation financing as part of their established preventive measures and internal controls; with respect to clear and consistent criteria, where appropriate, and in accordance with implementation, to the extent possible, of a risk-based approach.*** This assessment should be integrated with current CDD and risk analysis frameworks. The provision of criteria/indicators, guidance, and other relevant information by national competent authorities, whenever possible, would contribute to enhancing the quality and relevance of the risk assessment and effectiveness of preventative measures. ***The WGTM should undertake to further analyse the risk-based approach to proliferation financing, in collaboration with the private sector.***

- ***Option 12: Further analysis should be undertaken by the FATF to determine whether and how the FATF Recommendations dealing with CDD (Recommendations 5–9), and with FIs' internal controls (Recommendations 15 & 22), or their equivalents, could be applied to proliferation financing.*** This should be developed in collaboration with the private sector and the competent authorities, *e.g.* export control authorities. Likewise, enhanced cooperation between the competent authorities in charge of monitoring FIs/financial information and those in charge of counter proliferation should be promoted. Regular consultations could lead to national improvements in risk analysis that would benefit to the private sector.

Channels for Receiving Information

- ***Option 13: Goods lists, in themselves, should not be used as a basis for transaction screening by FIs, as they are difficult for those without a degree of technical expertise to interpret correctly which thus make them an inefficient safeguard.***

- ***Option 14: FATF should conduct further analysis, in collaboration with the private sector, on the types of information and guidance jurisdictions should provide to FIs to assist them in monitoring for proliferation financing activity.***

- ***Option 15: Recommendation 31, or equivalent provisions, should be applied to proliferation financing.***

- ***Option 16: Jurisdictions should consider whether and how suspicious and/or other transaction reporting mechanisms could be applied to proliferation financing.***

Awareness and Information Sharing

- ***Option 17: Jurisdictions should conduct outreach to the financial sector regarding proliferation financing, and incorporate a financial element within outreach to exporters.***

- ***Option 18: Jurisdictions should consider disseminating more widely the outcomes of legal proceedings relevant to proliferation financing, subject to their national legal systems.***

- ***Option 19: Jurisdictions should further examine possible typologies of proliferation financing and strive to identify further risk indicators.***

- ***Option 20: Jurisdictions need not encourage FIs to screen transactions on the basis of lists of controlled goods.***

- ***Option 21: Jurisdictions should consider making available lists of entities of proliferation concern, as a basis for screening by FIs, in the context of a risk-based approach and with respect to their legal framework. Jurisdictions which issue such lists should accompany them with clear guidance on their status and the basis on which entities are included, to ensure FIs do not use them in the same manner as sanctions lists.***

- ***Option 22: Jurisdictions should consider developing restricted forums and distribution mechanisms which could be used, when appropriate, to share relevant information with FIs.***

- ***Option 23: The FATF could consider undertaking further work to identify best practises in the area of information-sharing.***

ANNEX 1

PROJECT TEAM TERMS OF REFERENCE & MEMBERS

Objective of the Project Team

The Project Team has been tasked to develop policy options for the Working Group on Terrorist Financing and Money Laundering (WGTM) to consider as measures that could be considered in combating proliferation financing (PF) within the framework of existing UNSCRs (*e.g.* UNSCR 1540), in consideration of the PF Typologies Report and in consultation with the private sector. The Project Team will present its preliminary report to the WGTM June 2009 for consideration.

Project Team Terms of Reference:

- The Project Team will develop policy options for the WGTM to consider as measures that could be considered in combating proliferation financing within the framework of existing UNSCRs, such as UNSCR 1540(2004), in consideration of the PF Typologies Report and national legal frameworks. This work should build on the Issues for Consideration as outlined in the PF Typologies Report.

- The Project Team will actively seek input and comments from the private sector and other relevant stakeholders.

- The Project Team should strive to narrow down the number of options for the full working group (WGTM), but has no mandate to make final decisions; its findings will be fully discussed and considered by the full working group with a view to determining what further steps would be appropriate.

- To ensure maximum transparency, the Project Team leaders will provide to the Secretariat all documents underlying the team's work (including a team contact list, analysis of research findings and private sector feedback received) for upload to the WGTM secure website. Additionally, the Project Team will update the full working group, including through written summaries, at the February and June 2009 WGTM meetings.

- Under the leadership of one or two interested delegations, the work of the project team will be guided by a project plan, including a timetable for completion of the work.

- The Project Team will present its final report to the WGTM in October 2009.

Project Team Members

Project Team Co-chairs

Tom Neylan (United Kingdom)

Riccardo Sansonetti (Switzerland)

FATF Members

Australia

Canada

Japan

Kingdom of the Netherlands

European Commission

France

Germany

Italy

South Africa

Switzerland

United Kingdom

United States

FATF Associate Members

MONEYVAL (Romania)

International Organizations

Egmont Group

United Nations

ANNEX 2

TARGETED FINANCIAL SANCTIONS

1. This background paper is to explain the PFPT's discussion regarding the use of targeted financial sanctions to address WMD proliferation finance. In particular, this paper focuses on *i)* the value of targeted financial sanctions to address proliferation finance, *ii)* how targeted financial sanctions might be operationalised at a national or supra-national level, and *iii)* the principles that should be considered in development of guidance or an international standard in this regard.

I. Value of Targeted Financial Sanctions

2. Targeted financial sanctions can be a positive and effective measure in disrupting WMD proliferation finance networks. In addition, the PFPT agreed that targeted financial sanctions provide one possible effective avenue for meeting finance-related obligations under UNSCR 1540.

3. The value of targeted financial sanctions in combating WMD proliferation finance networks is much the same as it is in combating terrorist finance networks, as recognised by the FATF in the Best Practices Paper (BPP) for SR.III implementation. Specifically, the FATF has recognized that effective "freezing regimes" combat terrorism by:

- Deterring non-designated parties who might otherwise be willing to finance terrorist activity.
- Exposing terrorist financing "money trails" that may generate leads to previously unknown terrorist cells and financiers.
- Dismantling terrorist financing networks by encouraging designated persons to disassociate themselves from terrorist activity and renounce their affiliation with terrorist groups.
- Terminating terrorist cash flows by shutting down the pipelines used to move terrorist-related funds or other assets.
- Forcing terrorists to use more costly and higher risk means of financing their activities, which makes them more susceptible to detection and disruption.
- Fostering international co-operation and compliance with obligations under UNSCR 1267 and UNSCR 1373.

4. Targeted financial sanctions can achieve the effects above with respect to WMD proliferators and their support networks. In addition, there are elements of WMD proliferation finance, as well as the international legal framework that exists to address it, that suggest targeted financial sanctions may be particularly effective in combating WMD proliferation networks. Such factors include:

- **WMD Proliferation Finance Networks' Reliance on the Formal Financial Sector, Motivation by Profits.** As discussed in the FATF Typologies report on proliferation finance, proliferators and their respective procurement organizations abuse the formal international financial system to carry out ostensibly legitimate commercial transactions that, in actuality, support their efforts to procure proliferation-related items. Therefore, WMD proliferators may be even more susceptible to targeted financial sanctions than terrorist networks, which are more likely to use informal networks or cash couriers. Although proliferation-related transactions are also settled through opaque cash or "barter-like" settlements, this is not cost effective or efficient and is certainly suspicious. As a

result, proliferators may be more likely to seek access to the formal financial sector. In addition, some elements of the proliferation support network may operate for financial gain which may make them more susceptible to deterrence if authorities can credibly threaten to publicly expose or isolate them. By publicly exposing designated individuals and entities for their involvement with WMD proliferation, targeted financial sanctions jeopardise designated proliferators' access to the international financial system and put their commercial partners on notice of the threat they pose.[15] Those who continue to knowingly do business with them do so at the risk of tainting their reputations or even being designated themselves. This dynamic has the power to alter the decision-making calculus of proliferators and their support networks by clearly illustrating the costs of continuing to support proliferation activities.

- **Existing Counter-Proliferation Systems Focus on Physical Control of Specific Items.** Targeted financial sanctions can be a supplement to export control regimes. Export control regimes, when effectively implemented, can prevent the illegal export and trans-shipment of sensitive proliferation-related items, and allow authorities to control the movement of these items more generally. Although export control regimes may result in some disruption of the *financial* activities of specific individuals and entities involved in WMD proliferation, this is a side effect of export controls and may not adequately disrupt those financial activities. Therefore, while export controls are the key element for combating proliferation, targeted financial sanctions may supplement the effects of export control. Although those involved in the illegal export of sensitive proliferation-related items may be prosecuted and convicted under these regimes, there may be factual obstacles, *e.g.* the end-user will typically be in a different jurisdiction which might hamper prosecution. Experience with targeted financial sanctions in other contexts indicates that targeted financial sanctions may provide an avenue to address these difficulties in a counter-proliferation regime. Depending on the legal requirements in each jurisdiction, targeted financial sanctions can allow for the disruption of a wide range of actors in a proliferation network. Furthermore, targeted financial sanctions, when appropriately designed and implemented (see below), allow for the use of intelligence information and, according to the standards of the respective legal system, may also allow for taking action based on "reasonable grounds" or a "reasonable basis" which is generally a lower standard of proof than in the context of criminal prosecutions. These aspects of the targeted financial sanctions authority allow for preventative action against individuals and entities, which is critical in counter-proliferation regimes.

5. In addition to the factors above, targeted financial sanctions can add value to counter-proliferation efforts because they can be effectively implemented by the financial sector. Screening against official lists of WMD proliferation-related individuals and entities can be easily integrated into financial institutions' existing policies and procedures to implement targeted financial sanctions against a wide variety of other threats. Based on the PFPT members' discussions with the private sector in London, financial institutions largely agree that screening against verifiable lists is a manageable way to address proliferation financing. However, financial institutions emphasized the need for governments to provide specific identifiers of individuals and entities involved in proliferation financing in order to detect proliferators and proliferation transactions.

6. Finally, jurisdictions that have imposed targeted financial sanctions for proliferation financing have made the business activities of WMD proliferators and their supporters more burdensome. The U.S. experience in using targeted financial sanctions to counter WMD proliferation support networks indicates

[15] It should be noted that publicly exposing proliferators or their support networks may not be appropriate in all situations, such as those where it may jeopardise a law enforcement investigation. Such decisions should be taken on a case-by-case basis.

that several of these designated entities were forced to adopt costlier and more time-consuming business practices in an effort to mitigate the impact of sanctions. Effectiveness is greatly enhanced when targeted financial sanctions are implemented globally since the designated entity cannot as easily turn to third-country financial institutions to evade sanctions.

II. Implementing Targeted Financial Sanctions at the Operational Level

7. As in the counter-terrorism context, effective implementation of targeted financial sanctions at the operational level depends on adequate development of several key components at the national or supranational level. In brief, jurisdictions, when imposing targeted financial sanctions as one avenue to implement UNSCR 1540, should have in place:

- Adequate legal authorities and operational capacity.
- Ability to effectively identify and publicly "list" WMD proliferators and their supporters.
- Ability to provide notice to the financial sector and public and ensure compliance with sanctions.
- Appropriate means to address civil liberties and due process concerns.

8. While all of these components are critical to an effective targeted financial sanctions regime, there are several issues that are particularly relevant in the counter-proliferation context:

- **Establishing an appropriate legal authority.** U.S. targeted financial sanctions authorities related to counter-proliferation are unique in that they are built upon a pre-existing authority that can address any threat to the national security, foreign policy or economy of the United States. Jurisdictions seeking to create a targeted financial sanctions regime without such an underlying authority may consider building it on other existing national authorities – such as export controls – or limiting it to the implementation of existing international listing regimes – such as UNSCR 1718 or UNSCR 1737. The obligations that these resolutions impose to implement targeted sanctions are focused on North Korea and Iran, *i.e.* they are linked to specific states, and do not address other proliferation threats.

- **Ensuring the ability to identify and publicly "list" WMD proliferators and their supporters.** Although some UNSCRs provide lists of WMD proliferators (*i.e.* UNSCR 1718 and UNSCR 1737), implementation of these lists is not adequate to address other WMD proliferation threats. While the implementation of targeted financial sanctions is not a prerequisite for fulfilling UNSCR 1540, ensuring the ability to identify and "list" targets outside of the North Korean and Iranian contexts is a possible way of implementing UNSCR 1540. For some jurisdictions using that avenue, this will require significant new legal authorities (as described above), as well as significant operational changes to allow for disparate elements of their national governments to coordinate and identify individuals and entities for "listing."

- **Allowing for the use of sensitive intelligence in counter-proliferation targeted financial sanctions actions.** Given that the most valuable information related to WMD proliferation networks is often highly sensitive and controlled/classified by jurisdictions, it is critical that jurisdictions create the ability to use it in identifying targeted financial sanctions targets and

creating the necessary legal "record" to support their public listing. In any event, jurisdictions will have to weigh the advantages and disadvantages of publication of sensitive information.[16].

III. Principles to Consider

9. There are several key principles to consider:

- **Encourage an individuals- and entities-based approach within the context of state-based proliferation activities.** Although any WMD proliferation-related authority will necessarily address states' acquisition of WMD, the focus should be on isolating proliferation support networks, including individuals and entities involved in a particular state's proliferation activities or the "AQ Khan"-type actors involved in multiple states' proliferation activities. UNSCR 1540 specifically establishes obligations to address non-state actors' proliferation activities. A critical element in this issue is ensuring that any authorities encompass broader "support" activities.

- **Define an appropriate scope for the targeted financial sanctions authority.** As in the terrorist financing context, it is important for authorities to both freeze the assets of the designated entity and prohibit financial transactions with the designated entity. It is also important to allow for targeted financial sanctions that are either administrative or judicial in nature.

- **Provide for an approach which respects the competences in different jurisdictions.** Jurisdictions may have delegated national competences to a supranational level.

- **Acknowledge the need to implement existing UN proliferation-related sanctions "lists" as well as UN proliferation-related obligations that are not list-based.** Jurisdictions are already implementing financial provisions under relevant United Nations Security Council (UNSC) Resolutions that call upon the international community to protect against WMD proliferation through targeted financial sanctions on specific individuals and entities associated with North Korea's and Iran's nuclear proliferation programs and their delivery systems, as is clear in existing FATF non-binding guidance. Although UNSCR 1540 does not include an obligation to implement sanctions against listed entities, a possible list-based approach would be independent of existing obligations to implement targeted financial sanctions under existing UNSCRs relating to specific county-related proliferation lists.

- **Draw on FATF's Best Practices Paper (BPP) on Special Recommendation III.** FATF's recent BPP on SR III provides guidance that is relevant for the implementation of targeted financial sanctions against a different threat. In particular, the BPP's treatment of judicial review, listing, and other due process concerns should be incorporated into any policy options on targeted financial sanctions related to WMD proliferation.

[16] Such considerations should also ensure that the use of intelligence should not compromise ongoing intelligence operations.

ANNEX 3

APPLYING THE RISK-BASED APPROACH TO PROLIFERATION FINANCING

1. This background paper is to explain how the risk-based approach, including risk assessment and internal controls could be applied to proliferation financing.

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

3. The approach and layout adopted in this paper builds on the June 2007 FATF guidance on the '*Risk-Based Approach to Combating Money Laundering and Terrorist Financing: High Level Principles and Procedures*'.[17] The 2007 guidance was developed by the FATF in close consultation with representatives of the international banking and securities sector. Private sector partnership was an integral aspect in the development and finalisation of the guidance; consequently this paper has, where possible, mirrored the approach and layout adopted in June 2007 Guidance.

Risk-Based Obligations

4. The purpose of the risk-based approach is not the elimination of risk but rather that regulated entities involved in high risk activity understand the risks they face and have the appropriate policies, procedures and processes in place to manage such risk. This concept is already familiar to regulated entities and is well embedded within established risk analysis frameworks.

5. Financial institutions will only be in a position to conduct an efficient risk management assessment if robust information and objective criteria for the identification of risks are available. When assessing the applicability of the risk-based approach to Proliferation Financing, it is necessary to distinguish between:

a) Existing risk principles used in different contexts such as AML/CFT risk principles.

b) Risk principles which address the issue of proliferation financing for specific countries (such principles usually stem out of UNSCRs).

c) Criteria which may address the problem of proliferation financing in a general manner.

6. A clear distinction between these categories is necessary in order to properly assess the suitability of risk factors stemming from the abovementioned categories: Para. 5 deals with the applicability of AML/CFT measures to proliferation financing, Para. 11 deals with the issue of specific sanctions against certain countries, entities or organisations.

7. In addition to the general AML/CFT risk principles set out in the FATF standards there are specific risk measures applicable to financial institutions and designated non-financial businesses and

[17] http://www.fatf-gafi.org/dataoecd/43/46/38960576.pdf

professions (DNFBPs), these mainly fall into four areas (a) Customer Due Diligence measures (R 5 – 9); (b) institutions' internal controls (R. 15 & 22); (c) the approach to regulation and oversight by competent authorities (R.23); and (d) provisions related to DNFBPs (R.12, 16 & 24).

8. 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 similar traits as conventional money laundering. 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.

9. Furthermore the nature of the capacity in which a financial institution may be involved in certain transactions or services is equally important. For example, whilst some elements of CDD are universal the actual CDD process that an institution will perform will be dependent upon a wide range of factors and can vary significantly between financial institutions, type of transactions, the role it will be required to perform, the institutions own exposure through a particular transaction and specific regulatory requirements to which it is subject. Notwithstanding these limitations, regulated entities already have a number of frameworks in place that may potentially lend themselves to inclusion of proliferation risks, albeit in a more limited and targeted manner.

10. Regulated entities adopt a variety of approaches for considering risk. There is no individually defined methodology to determine risk for either money laundering or terrorist financing, however the most commonly identified criteria generally include – country/geographic risk, customer risk and product/service risk. The June 2007 FATF guidance on the 'Risk-Based Approach to Combating Money Laundering and Terrorist Financing: High Level Principles and Procedures' sets out the variables that may influence consideration of risk and the information that will be required to determine risk weightings.

11. Clearly in some circumstances the 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 specific proliferation sanctions, the obligations on regulated entities to comply with certain provisions are determined by these sanctions and are therefore subject to a specific risk-analysis as required to comply with these sanctions. Since such sanctions are tailor-made for specific risks and specific countries, they cannot serve as a model for developing a general risk-based approach to combat proliferation financing. 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. Moreover tailor-made sanctions for specific risks and countries are the preferred mechanism for dealing with proliferation concerns as these have proven to be an efficient tool.

12. In implementing the risk-based approach of 2007 there are four key elements – all of which are inter-related and underpin this work – these include (a) customer due diligence; (b) monitoring of customers and transactions; (c) suspicious transaction reporting; and (d) training and awareness. For the purposes of this paper we consider two stages: Risk assessment and Risk management.

Risk Assessment

13. Introducing proliferation financing within current risk assessment practises should be proportionate given the overall proliferation risk associated with the activities undertaken by the institution. For example, an institution operating internationally and/or with an international client base will generally be expected to assess a wider range of risks, including proliferation, compared to a smaller domestically-focused institution. Higher risk areas should be subject to enhanced procedures; this could include measures such as enhanced due diligence checks and enhanced transaction monitoring. It also follows that in instances where risks are low, simplified or reduced controls may be applied. A prerequisite

for any efficient risk assessment is, however, the availability for objective criteria for detecting proliferation financing.

14. In order to implement a reasonable risk-based approach, financial institutions will need to apply objective criteria to assess potential risk. Financial institutions should be able to make such an assessment on the basis of their own expertise and where relevant on the basis of information provided by government agencies.

15. A risk-based approach should not be designed to prohibit financial institutions from engaging in transactions with customers or establishing relationships with potential customers, but rather it should assist financial institutions to effectively manage potential proliferation risks. Equally it should be recognised that even reasonably applied controls will not identify and detect all instances of proliferation.

16. It would be impractical to expect financial institutions to develop a dedicated risk-assessment framework for assessing proliferation financing risks alone. A more achievable goal would be to include proliferation consideration alongside the wider determination of risks factors. Moreover, established mechanisms utilised to conduct risk assessment and identify suspicious activity of wider criminal activity may, in some instances, be applicable to proliferation considerations.

17. On this basis the following information could be incorporated into current risk deliberations.

Country/geographic risk

18. 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) and 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. As a consequence a financial institution may already be subject to vigilance requirements stemming out of the specific mandatory legal obligations related to a sanctioned country.

19. 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. As noted in the FATF proliferation financing typology only 80 jurisdictions have any export controls related to WMD, however individual country compliance with export control obligations are not currently published. In the absence of such information financial institutions 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 were forthcoming – either at an international or individual government level – it could provide an additional factor that could potentially inform country risk assessment.[18]

Customer risk

20. Any assessment of the risks that a customer may pose will be underpinned by customer take on procedures and developed further by ongoing customer due diligence obligations. In their risk assessment, financial institutions have to distinguish between their various customers, *e.g.* the exporter, the end-user in the concrete underlying transaction or the correspondent bank acting upon request of the end-user.

[18] During the consultation phase some private sector representatives have indicated that they would wish to have further information on which countries have weak or non-existent export controls.

Customers are per se subject to due diligence requirements. Specific categories of customers whose activities may indicate a higher proliferation financing risk could potentially include:

- Exporters engaged in transactions with end-users listed in 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.[19] Importantly such type of lists are not embargo lists, but rather – in a similar manner to how lists of Politically Exposed Persons (PEPs) are intended to be used – they highlight entities which pose an elevated concern and should be considered accordingly in deliberations on appropriate levels of due diligence and on-going monitoring.

- End-user is a listed military or research body connected with a high-risk jurisdiction of proliferation concern.

- The involvement of the customer in the supply, purchase or sale of dual use goods calls for a more differentiated approach: Financial institutions rely on export control regimes and custom authorities to police the activities of exporters which 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 per se not an indicator for a financial institution. 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 FIs. 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.

Product and Service Risks

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

- Delivery of services to certain identified high risk entities *i.e.* correspondent banking to Iranian institutions identified in EU Reg1110/2008 or correspondent banking to countries subject to relevant UN Sanctions.

- Project Financing and complex loans where there is a presence of other objective risk factors, such as an identified end user.

- Delivery of financial services, including trade finance services[20], where there are other heightened risk factors, such as an identified end user of concern.

22. As is the case with anti-money laundering any assessment of risk will need to take into account 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

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

[20] Trade finance can in its broadest interpretation, be described as being the finance by Fis of the movement of goods and services, both within a country's boundaries as well as cross border. Trade finance activities comprise a mis of money transmissions, default undertakings, performance undertakings and the provision of credit facilities (Wolfsberg Trade Finance Principles, 2008).

would be disproportionate to assess a stable known customer who has been identified as involved in the supply, purchase or sale of dual use and sensitive goods as either moderate or high-risk for that reason alone.

23. However, the overall assessment of risk may increase with the presence of other objective factors *i.e.* the type and nature of principal parties engaged in the transaction / unusually large transactions compared to transactions what might be reasonably expected of customers of a similar profile, if the financial institution is in a position to make this assessment out of its own expertise. Consideration of these risks, including customer-specific information, and mitigating factors, will enable a financial institution to reach a graduated understanding of the degree of proliferation finance risk they pose.

24. There are also certain circumstances where the ability of a financial institution to detect suspicious activity will be constrained. For instance, in the case of fragmented trade finance arrangements the availability of information will be a particularly limiting factor in enabling financial institution to understand who the ultimate buyer (or seller) of a product is, or what the ultimate end use of product may be. Whilst all financial institutions are expected to have a form of financial transaction monitoring in place the information presented to a financial institution will clearly vary according to their role in a particular transaction and the type of payment system used. For instance in the case of letters of credit the institution 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.

Mitigating Factors

25. Mitigating factors should also be considered when assessing risk, for example whether the customer is themselves aware of proliferation risks and has systems and processes to ensure their compliance with export control obligations.

Risk Management: Application of the Risk-Based Approach and Reporting Suspicious Activity

26. In a similar manner to terrorist financing, financial institutions' ability to detect and identify potential proliferation financing transactions is limited. Without guidance, suitable typologies or acting on specific intelligence provided by the authorities, this not possible. For this reason any obligations on the regulated sector should be accompanied by appropriate information exchange between the public and private sector. Countries should consider who is best placed to contribute to information sharing processes, at a minimum this is likely to include, FIU and law enforcement.

27. The types of proliferation financing related information that could reasonably be shared (where available) includes:

- National Lists concerning high-risk entities.
- Issuing of industry alerts by the FIU (or another appropriate body) that highlight evasion tactics *i.e.* companies that deliberately disguise their identities in order to evade both international/national sanctions, countries of corporate origin and/or country payment destination.
- National typologies on how proliferators have accessed and exploited the regulated sector.
- Feedback on suspicious transaction reporting.

- Information on commonly used diversion routes and/or information economic zones with weak export controls.

- Targeted de-classified intelligence.

28. A predominant rationale in the application of the risk-based approach is that regulated entities implement appropriate measures and controls to mitigate the risk of those customers determined to be high-risk. This will obviously include enhanced due diligence, increased monitoring, enhanced frequency of relationship reviews and senior management approval. These measures and controls may often address more than one identified risk, and it is not necessary that a regulated entity introduce specific controls for each risk. For instance, risks associated with proliferation financing are likely to be integrated in the financial institution's risk monitoring covering general customer-, country- and product-risks which do not necessarily stem from proliferation financing.

29. Furthermore, using existing AML/CFT controls against the threat of proliferation financing provides the additional benefit of allowing financial institutions to rely on familiar concepts, processes and procedures. Additional Information that may be specifically useful to assessing proliferation risks could include further information on the parties to a transaction.

30. In the automatic monitoring of transactions the drivers that flag out '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

31. Alerts generated from these automatic systems are usually subject to some type of human intervention. Therefore, the effective application of the risk-based approached within monitoring would benefit from intelligence-based risk indicators.

32. Real time screening on proliferation financing appears most effectively utilised in complying with entity based sanction requirements. There appears a limited scope for including activity-based measures within current real time screening systems if available and technically feasible.

33. It is conceivable that a financial institution develops a suspicion of proliferation financing through customer due diligence, risk assessment and internal controls. In such cases there should be a right or obligation to report suspicion to a competent authority, *e.g.* the FIU.

Conclusions and Policy Options

34. Taking the FATF June 2007 guidance on the '*Risk-Based Approach to Combating Money Laundering and Terrorist Financing: High Level Principles and Procedures*' as a starting point, the following could be further analysed:

(i) Regulated entities, as part of their established preventive measures and internal controls, should, where appropriate, incorporate the risk of proliferation financing. This assessment should be integrated with current customer due diligence and risk analysis frameworks. In the main this is likely to be narrowly focused towards entities of concern.

(ii) The greatest opportunity for intervention and enhanced due diligence will be in instances where there is direct banker/compliance engagement *i.e.* large structured or complex transactions which require specific authorisation.

(iii) Ongoing risk-based transaction monitoring would benefit from greater consideration as to the types of indicators (if available and feasible) beyond entities of concern, which may be applicable to proliferation financing.

(iv) Obligations on the regulated sector should be accompanied by appropriate information exchange across public sector agencies and between the public and private sector, subject to the requirements of data protection laws.

(v) Financial Institutions should have the right or obligation to report a suspicion to a competent authority, *e.g.* the FIU.

(vi) WGTM should undertake to further analyse the risk-based approach to proliferation financing, in collaboration with the private sector. This analysis should include how proliferation considerations can be incorporated within country/geographic risk, customer risk and product/service risk analysis. It should also set out the appropriate controls for high-risk situations, including *e.g.* enhanced customer and transaction monitoring.

ANNEX 4

PFPT: SUMMARY OF PRIVATE SECTOR OUTREACH

I. General Comments on the Report

1. The organisations that provided comments on the Report ("respondent organisation" or "organisation") unanimously welcomed the outreach. Especially, providing them an opportunity to comment at an early stage of the discussion was appreciated.

2. Most of the respondent organisations also commended the fair and well-balanced description and analysis of the Report. More specifically, they positively evaluated that the Report acknowledges: *(i)* the limited role and constraints of FIs in proliferation financing (PF); *(ii)* the issue of cost-effectiveness of the measures against PF; and *(iii)* a clear division of responsibilities between the financial sector and export control authorities. With this general appraisal, the Report was recognised as a good basis for further discussion and work on this issue.

3. There were a few comments on the structure of the Report, One organisation suggested that the role of national jurisdiction and industry be more clearly differentiated throughout the policy options. Three organisations suggested that the final Report would be improved by: *(i)* accompanying numbers with Policy Options throughout the text; and *(ii)* by moving the list of Policy Options in Chapter VIII towards the front of the Report.

II. Definition of Proliferation Financing (Chapters I-III)

4. ***Policy Option 1*** (definition of PF)***:*** Most of the respondent organisations submitted comments on the definition of "*proliferation financing*". The comments can be divided into the following four groups:

1. ***Lack of "knowledge"' in the definition may create unreasonable liability for FIs:*** Many organisations expressed concern about the description regarding the "*knowledge*" of proliferation financing in the context of criminal liability (the 3rd bullet of paragraph 27 and the footnotes 5 and 8). The underlying concern is that FIs could be prosecuted if the definition of PF does not contain the subjective element (*i.e.* the knowledge that the transactions involved in any proliferation activity). This issue also affects to the issue regarding who should primarily be responsible for counter-proliferation and PF, which is discussed in Chapters II, III and VI. In relation to this, two organisations suggested the following alternative descriptions regarding the subjective element of the definition (the 3rd bullet of paragraph 27):

> ***Proposal 1* :**
>
> - The definition of an <u>*act*</u> 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. As such, ~~both knowledge and intention will be relevant in specifying any related criminal offense (see next section).~~<u>the intentional provision of financing or financial services in support of a trade transaction when the FI has actual knowledge of the illicit purpose of the transaction will be prerequisite to the specification of any related criminal offence."</u>

***Proposal 2*:**

- 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. As such, ~~both~~ intention and knowledge ~~and intention~~ to support an act of proliferation will be relevant in specifying any related criminal offense (see next section).

2. ***Scope of the term "financial services":*** Many organisations also expressed concern about the concept of "*financial service*" in the proposed definition. Since neither the proposed definition nor the existing FATF standards provides a concrete definition of "*financial services*", it is not clear what financial services could be included in the scope of criminal offence. This will also have implications in terms of what types of FIs may be subject to obligations in relation to counter PF (*e.g.* question were raised regarding the responsibility of insurance companies/services and intermediary FIs). Some organisations also called for guidance on how to delineate between legitimate activities for which financial services can be provided and those for which financial services may not be provided. Some organizations requested a more strict and limited definition.

3. ***Consistency of terminology:*** Two organisations expressed the view that the same terminology should be used for the definition of WMD as described in the corresponding international conventions and resolutions. This would ensure that the Report and the FATF's policy response are consistent with existing international requirements.

4. ***Acknowledgment of the nature of PF:*** One organisation emphasized that the definition needs to articulate the challenges that both the private and public sectors would face, and proposed to add a sentence at the end of the definition in *Policy Option 1*.

***Proposal*:**

Proliferation financing refers to:

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. By its nature, proliferation financing may not be readily distinguished from normal, legitimate transactions.

III. Proliferation Financing vs. Export Control (Chapters II-III)

5. With regard to the description of the Report concerning the role of export control and proliferation financing, or the role of export control authorities and FIs, many organisations submitted comments. Overall, respondent organisations are of the view that, in the area of counter proliferation, it is primarily the responsibility of the government/quasi-government in charge of export control authorities to take the primary role; the role of private firms and FIs can only be supportive but not substitutive. Based on this fundamental recognition on the role of FIs, respondent organisations elaborated the following four issues.

1. Although there are some areas of overlap with AML/CFT measures, measures to counter PF, including the control of exports, is a totally different process.

2. A consistent international implementation of export controls is a prerequisite for effective counter proliferation financing measures.

3. New measures against proliferation financing should not be a duplication of existing export control rules as this would unnecessarily increase the burden on FIs.

4. Measures to counter PF should not place a disproportionate compliance burden on FIs which could undermine their competitiveness.

6. With these potential consequences, some organisations suggested that consideration should be given to: *(i)* the cost effectiveness of any new rules/measures to counter PF, and *(ii)* an establishment of a line of communication between FIs and export control authorities.

IV. Legal System/Criminalisation (Chapter III)

7. Overall, this chapter discussing a legal system of criminalising proliferation financing has drawn only a few direct comments from the respondent organisations. This implies that a universally accepted definition and scope of PF are critical first steps for industry before considering the legal framework of criminalisation. One organisation advised that crimialisation of PF could derive PF-related transactions underground, and emphasised that the FATF and jurisdictions should analyse this potential ramifications.

8. ***Policy Option 3*** (asset forfeiture): Only one organisation referred to this option, and they agreed to the importance of confiscating proceeds and instrumentalities of PF acts. In the meantime, they noted that the rights of bona fide third party (*e.g.* FIs holding collateral of customers) should not be unfairly prejudiced.

9. ***Policy Option 4*** (financial investigation): Only one organisation referred to this option, and they agreed to the importance of financial investigation. They also emphasised that FIs would need clear guidance and information from the relevant authorities to assist investigation by identifying and providing useful information.

10. ***Policy Option 7*** (further analysis of criminalization): Two organizations supported this policy option which recognises the need to further analyse different approaches towards criminalisation of PF. One organisation emphasised the importance of a consistent international sanctions regime and coordinated action by national regulators through the implementation of UNSCRs.

V. Targeted Financial Sanction (Chapter IV)

11. All respondent organisations that provided comments on targeted financial sanctions supported the idea of a list approach. In the meantime, two organisations expressed a somewhat cautious view that, unlike UN sanction lists, not all lists produced by individual jurisdictions can be shared by jurisdictions, and that manual verification may also be required in certain cases.

12. Reflecting the FIs' experiences, organisations emphasized that the list should meet the following specific requirements/conditions:

1. the list should be internationally harmonised;

2. the list should contain sufficient identifiers of the targeted person/entity; and

3. the list should be in certain data formats that are compatible with FIs' screening tools.

13. One organisation emphasized that: *(i)* the targeted financial sanctions need information sharing with the relevant authorities to distinguish PF-related transactions from legitimate transactions, and *(ii)* clear guidance and procedure (*i.e.* what information can be shared, and when and how the information is provided to FIs) are necessary, and *(iii)* FIs need to be legally protected when they implement measures based on the provided information (for implementing the sanction).

VI. Responsibilities of Financial Institutions (Chapter V)

14. ***Policy Option 11*** (RBA): This option calls for FIs to incorporate risk of PF "with respect to clear and consistent criteria"—a phrase that has drawn the attention of many respondent organisations. The following three main themes emerged:

1. Those organisations who interpreted this option as calling for a sanctions list (*i.e.* of designation persons and entities), welcomed this approach (as opposed to "activity") and emphasised that the list should be "actionable" with clear and sufficient identifiers of the targeted person/entity.

2. Many organisations expressed strong concerns about the application of the risk-based approach (RBA) to proliferation financing. These concerns are based on the fact that: *(i)* proliferation finance is a new area for the financial sector with little expertise and knowledge, and *(ii)* the payment system through FIs is not designed to assess the underlying transactions. Quite a few organisations questioned whether a RBA is applicable to proliferation financing, and one organisation suggested that the clarification of the definition of PF be the first priority. Another organisation indicated that, unlike CDD for AML/CFT purposes, the RBA can be applied only in cases where indicators of proliferation risks are present. Many respondent organisations welcomed that the criticised "red flag" notion is not anymore mentioned in the report.

3. Three organisations expressed serious concern that it is not possible for FIs to carry out "general vigilance" against PF. One organisation did not argue against the application of CDD measures to PF, but emphasised that information and clear guidance need to be provided by the relevant authorities.

VII. Channels for Receiving Information (Chapter VI)

15. ***Policy Option 13*** (screening by goods list): Many respondent organisations strongly supported the view that goods lists should not be used as a basis for transaction screening, and suggested that stronger language (*e.g.* "must not") is preferable. Many organisations that referred to this Policy Option also suggested that more positive description in paragraph 70, which emphasises the limited ability of FIs to implement activity-based controls against proliferation, be included. Additionally, the following specific comments were made.

1. The introduction of goods list would only result in providing an extra administrative burden to national authorities which need to respond to queries from FIs.

2. There seems to be a conflict in the description of the Report and Annex 3 (par.20). While the Report does not encourage monitoring by goods-list (*Policy Option 13*), Annex 3 expects FIs to consider that the involvement of dual-use goods in a supply, purchase or sale may be of some relevance as a risk factor.

16. ***Policy Option 14*** (monitoring): Many respondent organisations supported the idea and the effectiveness of monitoring, as long as it is post-transaction monitoring. In light of FIs' lack of

expertise/knowledge of proliferation-related transactions, many organisations suggested that the monitoring be conducted based on information, especially a list of entities, provided by the national authorities or other bodies. Additionally, the following specific comments were made.

1. Monitoring should only be required only in relation to "hits" on a list of sanctioned persons and entities.

2. FIs do not have practical opportunity to apply the "activity-based" approach and the types of risk introduced in the Annex 3 of the Report (*i.e.* country/geographical risk, customer risk, product/service risk).

3. Additional useable information relating to PF typologies, if identified, would be welcome.

17. ***Policy Option 16*** (reporting and STR): Various cautious views were expressed on reporting, including suspicious transaction reporting. The views are slightly different by organisation, but they can be summarised into three themes:

1. Sufficient information should be provided to FIs to identify what sort of activities/transactions should be recognised as suspicious or as an indication of PF;

2. A reporting obligation should be limited to instances where there is a hit on a sanctions list. In other circumstances, FIs should have a right (but not an obligation) to report; and

3. Reporting should be made to the export control authorities, rather than the AML/CFT authorities. Additionally, two organisations questioned whether a report submitted to the export control authorities (rather than the AML control authorities) can be defined as a "suspicious" transaction report (as is the case in the context of AML/CFT). For example, depending on the definition of *proliferation financing*, an FI could be involved in proliferation financing in a situation where there was no realistic prospect of being able to spot the problem.

VIII. Awareness and Information Sharing (Chapter VII)

18. ***Policy Options 17*** (outreach) and ***22*** (information sharing): Many respondent organisations supported the policy option on outreach and information sharing (from relevant authorities to FIs), as it would significantly increase the effectiveness of FI's monitoring. On the contrary, organisations (especially those representing FIs) were cautious about providing customer information to the relevant authorities. Many organisations also suggested that there should be arrangements that exempt FIs' from civil and criminal liability. One organisation expressed doubt about whether the authorities would provide sensitive information to FIs.

19. ***Policy Option 20*** (not encouraging screening based on controlled goods): Many organisations supported this option, but (consistent with the response to *Policy Option 13*), some organisations expressed a preference for more positive and stronger language, such as "should not". Here again, one organisation pointed out a conflict between this Policy Option and the description of Annex 3 (para.20, 3rd bullet).

20. ***Policy Option 21*** (list of entities with clear guidance): Many organisations expressed strong reservations about this policy option. The underlying concern comes from the (civil or criminal) responsibility that the FIs would have to take, especially vis-à-vis their customers. This concern is also applied to the reservations expressed about ***Policy Option 22*** (information exchange). With this reservation, respondent organisations made the following specific comments:

1. The role/duty of FIs in relation to a sanctions list should be clarified by law/regulation.

2. The nature and the legal status of the list need to be clarified.

3. The list should be formatted and be of good quality.

4. International co-ordination with regard to the list and related obligations need to be ensured.

5. The resource implication for FIs also needs to be taken into account.

21. In relation to the language in the Report, one organisation suggested that the Report needs to clarify the consistency of language used to describe "monitoring" (*Policy Option 14*) and "screening" (*Policy Option 21*), especially focusing on whether both are referring to "post" monitoring/screening.