

## **Money Laundering Bulletin, December 2009/January 2010, Issue 169**

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### **Muddy Waters**

At 10.30am on Monday 12 October, HM Treasury's first 'direction' under Schedule 7 of the Counter Terrorism Act 2008 (CTA) - The Financial Restrictions (Iran) Order 2009 - came into force. In essence, writes Mark Dunn of LexisNexis, the direction requires that firms in the UK financial services sector do "[N]ot enter into or continue to participate in any transaction or business relationship" with two Iranian entities, Bank Mellat and the Islamic Republic of Iran Shipping Lines (IRISL) (or their branches), for 12 months. The Treasury issued the direction "[I]n response to the significant risk to the UK's national interests posed by activity in Iran that facilitates the development or production of nuclear weapons."

The CTA gained Royal Assent on 26 November 2008 and came into force on that date. The Act provides HM Treasury with an additional means (alongside the Money Laundering Regulations 2007 [MLR 2007] and sanctions regime) to tackle money laundering, counter terrorist financing and to reduce the proliferation of nuclear, radiological, biological or chemical weapons. The heart of this legislation gives HM Treasury new powers to issue 'directions', which instruct selected or all firms in the UK financial sector to change the way they conduct business with individuals and companies in certain countries. It may mean reclassifying these entities as a higher risk and limiting their access to certain financial products and services. A direction may also require firms to conduct enhanced customer due diligence (EDD) checks and ongoing monitoring of such business relationships. In some cases firms will also have to provide government with information and documents relating to business conducted with these entities or even cease such business relationships altogether. Failure to comply with CTA Schedule 7 carries a potential fine and/or prison sentence of up to two years.

Schedule 7 was introduced without industry consultation. The government view is that as financial services firms already have in place robust anti-money laundering (AML) processes to comply with the MLR 2007, those banks and other financial institutions affected should be able to react quickly to a Treasury direction and adapt their existing systems and controls as required. There are some concessions for insurance companies, which, unless they operate in the life assurance sector, have not had to apply the MLR 2007 to date and therefore do not have existing AML processes in place. In consequence, as appropriate, non-life firms will only have to respond to the business cessation and reporting requirements that may be contained in a direction.

In theory, the AML customer due diligence (CDD) and ongoing monitoring procedures implemented by firms within the financial services sector do provide some of the framework required to respond to a Treasury direction. However, in reality, the practicalities of complying with Schedule 7 introduce further confusion to firms already trying to deal with the ambiguity and inconsistencies of the risk-based approach present in the MLR 2007. At the same time, firms are having to deal with the complexities of complying with an international sanctions regime also aimed at tackling money laundering and terrorist financing.

## **Flexible, but compatible?**

By enabling the Treasury to issue directions under the CTA, the aim is to provide government with powers that offer more flexibility than the sanctions regime and its focus on asset freezing and business cessation measures. However, Schedule 7 muddies the waters between AML and sanctions, neither being fully consistent with best practice under MLR 2007 nor the approach taken by the Treasury with UK financial sanctions.

The entities targeted by the first Treasury direction serve to highlight the growing confusion of the sanctions regime. At one end of the spectrum, the US Treasury's Office of Foreign Assets Control (OFAC) has had sanctions in force against Bank Mellat and IRISL since they first appeared on the OFAC Specially Designated Nationals and Blocked Persons list back in November 2007 and September 2008, respectively. As a result, any UK company with a US listing will already be unable to conduct any business with these companies.

## **A direction without listing**

In contrast, neither of the Iranian entities above appears on HM Treasury's sanctions list. However, confusingly, this appears to contradict the UK's stance on Iran and the government's support of the United Nations sanctions regime where financial sanctions are introduced by the UN: "[A]gainst those who engage in, directly associate with or provide support for Iran's proliferation sensitive nuclear activities or the development of nuclear weapon delivery systems, or persons or entities acting on their behalf or at their direction, or entities owned or controlled by them."

Despite the Ministerial Statement setting out the reasons given for the Schedule 7 direction issued on 12 October 2009 - "[I]n response to the significant risk to the UK's national interests posed by activity in Iran that facilitates the development or production of nuclear weapons" - this inconsistency is further illustrated by a press notice issued by the Treasury a month later on 10 November entitled, "Statement on money laundering controls in overseas jurisdictions". The press notice draws attention to an earlier Financial Action Task Force (FATF) statement published on 16 October, which highlights concerns with the lack of money laundering controls within a number of jurisdictions, including Iran. The Treasury press notice acts as broader warning to all sectors regulated under the MLR 2007 to: "[T]reat transactions associated with Iran as situations that by their nature can present a higher risk of money laundering or terrorist financing, and which therefore require increased scrutiny, enhanced due diligence, and ongoing monitoring."

The press notice goes on to state that: "All other persons authorised by the Financial Services

Authority should also take this advice into account in respect of their systems and controls to counter financial crime, and take appropriate actions to minimise the associated risks."

The press notice continues by citing the 12 October direction as an example of how the Treasury is responding to warnings from the FATF (issued in its 16 October update), and yet the direction is only aimed at the financial services sector given Schedule 7's scope and, as a result, is likely to have received scant attention from any other firms regulated under MLR 2007.

## **Licence to report more**

Further confusion arises in the administration of the direction. Although the UK financial services sector was specifically instructed to stop any transactions or business relationships with Bank Mellat and IRISL, unlike the sanctions regime, where a hit against the Treasury list during the CDD process essentially means that business relationship goes no further, Schedule 7 of the CTA allows HM Treasury to grant licences exempting specific transactions or business relationships from the requirements of a direction. Three licences were issued by HM Treasury following the order on 12 October. The first licence enables accounts and funds belonging to Bank Mellat and the Islamic Republic of Iran Shipping Lines to be managed on an ongoing basis as long as the Treasury is notified of the existence of such accounts and any subsequent activity undertaken with the account by the two subject companies. The second licence effectively enables financial institutions to complete any contractual or other agreed payments that relate to business undertaken prior to the 12 October direction. Again, the Treasury must also be notified of the details of any such contracts and the parties involved. The third licence enabled firms to continue to provide insurance cover to the two Iranian companies for seven days following the direction as long as the Treasury was provided with full details on the insurance agreements in place.

Having been instructed to cease transactions and terminate business relationships, financial institutions essentially have to put such activities in limbo, while a licence is requested, prior to proceeding with business or not depending on the Treasury's response. Licences may also be revoked at any time. This leads to an additional burden on existing anti-money laundering processes as every transaction involving Bank Mellat and IRISL will need to be scrutinised and effective reporting procedures put in place to ensure that HM Treasury is notified accordingly. Untangling and reporting on complex arrangements like letters of credit, trade bills and guarantees amongst other financial services adds more to the workload of the Compliance department, already creaking under the weight of both doing 'more with less' due to the recession and the relentless growth of regulation.

## **Subject to interpretation**

As an indication of the confusion associated with the direction, following its publication together with the above licences, on the 12 October, the Treasury issued a follow-up note on 30 October to further clarify what parts of the "interpretive note" that originally accompanied the direction actually mean. Additional definitions were provided explain the meaning of direct payments to and from the named entities and the term 'instructor' used in the interpretive note. This complementary note also includes the caveat that "Firms may wish to obtain legal advice regarding whether their arrangements constitute a 'business relationship'" *via-à-vis* HM Treasury's view of direct transactions involving Bank Mellat or IRISL. This ambiguity again puts extra work on the Compliance department to further establish the extent of their firm's exposure to risk from the direction.

It is still too early to determine the impact that Schedule 7 will have on the UK financial services sector and it is unlikely that the legislation will be covered by the Review of Money Laundering Regulations 2007, announced by HM Treasury in October, considering the defined remit and short deadlines. However, given the inconsistencies between Schedule 7 and the sanctions regime and the fact that that government had to publish additional clarification to support the direction and its "interpretive note", handling of the first direction has not been smooth. This is an

issue, as the first direction focused on entities that, in the main, were unlikely to raise too much concern with the financial services sector - both Bank Mellat and IRISL were already on the US Office of Foreign Assets Control (OFAC) list, which means that most financial institutions would have ceased dealing with them some time ago.

The long arm of OFAC has also led many of the larger banks proactively to reduce their exposure to jurisdictions like Iran that are deemed higher risk as the compliance burden increasingly outweighs the returns available. So, in theory, this first direction should have been a simple test to prove the effectiveness of Schedule 7 rather than, in practice, an order open to ambiguity and misinterpretation. We await the next direction with interest to see if compliance proves any easier.