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Cross-Border Coherence in the Effective Design and Implementation of Financial Sanctions and the Prevention of Sanctions Evasion: Lessons Learned and Issues Going Forward

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BACKGROUND

The Russian attack on Ukraine has led to the application of wide-ranging financial sanctions by multiple jurisdictions around the world. Though throughout this crisis we have seen unprecedented cooperation across the G-7 countries and beyond, the design and implementation of sanctions may always elicit differences dependent on wider geopolitical considerations. However, where there is common cause among countries to use such tools, it is vital that the action of the official sector is internationally coordinated and coherent and that certain elements are harmonized across regimes. A focus on the means to preclude the evasion of financial sanctions is also necessary when circumvention prevention mechanisms may not be uniform in nature on a cross-border basis.

As such, this paper seeks to outline key lessons learned from sanctions regimes adopted thus far concerning the Russia-Ukraine conflict and related antecedent actions, and it reflects upon important issues for the mitigation and prevention of sanctions evasion going forward. Consideration of these issues will assist in achieving core national and international security objectives by helping to ensure current and future financial sanctions - wherever devised - deliver meaningful outcomes in a globally consistent and effective manner whilst obviating challenges with compliance and avoiding possible unintended consequences.

Key Issues:

1. THE DESIGN AND IMPLEMENTATION OF FINANCIAL SANCTIONS:

a. Harmonization and Coordination

Great strides have been made in developing close cross-border cooperation in response to the invasion of Ukraine by Russia in February 2022. These efforts have built on years of good work between the G-7 and the wider global community to effectively deploy economic security measures to address common strategic threats by pooling expertise and strengthening relationships. Work on coordination has been both bilateral and multilateral and it continues to expand as the war persists.¹

¹ Examples include enhancements to the US-UK Sanctions Partnership, whereby OFAC and OFSI officials committed to working on implementation and enforcement of financial sanctions by further exchanging best practices and strengthening working relationships at all levels: US Department of the Treasury, October 17, 2022; and work at Europol through the Europol Financial Intelligence Public Private Partnership (EFIPPP) Circumvention of Sanctions Work Stream which coordinates law enforcement, Financial Intelligence Units, Regulators and the private sector across the EU and beyond.

However, it is well recognized that disparities between sanctions regimes can create implementation and compliance obstacles, particularly for global financial institutions but also for those authorities charged with sanctions enforcement. Differences have been noted in areas such as lists of designations, asset freeze and travel bans, capital market restrictions, and export controls. The most impactful inconsistencies are experienced between jurisdictions with the widest-ranging sanctions regimes concerning listings, geographical applicability, scope of exceptions, and time of entry into force.

Such differences can bring about deleterious consequences for the structure of the sanctions programs themselves. The rapid nature of the sanctions response can also make the understanding of them more complex. This creates compliance challenges to the extent that cross-border business necessitates quick reactions, whereas the analysis of new sanctions policy that differs across countries often requires time.

Consistent and early coordination amongst international authorities, along with greater harmonization across jurisdictional regimes, will help with more effective compliance and increase the impact such measures will have in support of security and policy goals. As such, a continued focus on greater harmonization in the following areas for current and future sanctions policy would include:

i. Prohibitions/lists of sanctioned individuals; sectoral application; and the timing of designations across jurisdictions

Challenges arise specifically in areas where divergence across sanctions regimes concern issues of prohibitions, lists of sanctioned individuals, and targeted sectoral anomalies. Common objectives are often apparent and coordinated by countries; however, differences in scope and level of detail in certain restrictive measures can lead to significant implementation challenges for global financial institutions and authorities charged with oversight. Such issues should be corrected as much as practicable at the outset of sanctions design and before implementation.

For example, the review of transactions by financial institutions that cross multiple jurisdictions face operational challenges when seeking to apply divergent prohibitions to the same target. Novel sanctions, or those with a specific sectoral focus lacking in other regimes, present even greater implementation challenges, particularly when such prohibitions require guidance upon issuance and are directed at nationality/ residency rather than named parties. This has been particularly apparent in the case of designations of members of the Russian political and financial elite in the wake of the Russian invasion.

Sanctions targets which are designated at different times by different jurisdictions also create complications. Targets which are designated by one or two jurisdictions but not others - or are subject to different sanctions prohibitions - can heighten the complexity of cross-border implementation. This can generate confusion in the implementation of asset freezes, for example, as one party would be handled differently depending on the jurisdiction.

More generally, issues are also present concerning the onboarding of accounts at financial institutions for clients who may not be sanctioned but who potentially risk future sanctions action which may differ across jurisdictions. The same applies to the processing of complex transactions directly or indirectly involving parties or goods where there is concern that the transaction could involve a future sanctioned party or a violation of potential sectoral sanctions.

ii. Ownership and control tests

Particular challenges arise in the asymmetry of information for the application of ownership and control tests, and this should be considered as authorities work on coordinated cross-border sanctions policy. Jurisdictions may apply different standards for determining whether an entity is sanctioned based on ownership or control by multiple sanction targets. Countries may also differ on the aggregation of individual holdings for the purposes of determining sanctioned status based on ownership, which can lead to inconsistent results.

Under other jurisdictional constructs, it is often left to the financial services industry and other stakeholders to determine whether an entity is considered sanctioned. While some guidance may be applied regarding factors that establish control, case-by-case determinations based on subjective factors are often left to the private sector. These determinations frequently require factual information that may only be obtained from the potential sanctions target, creating practical and operational challenges.

For instance, the legal assumption arising from the control over a subsidiary by its mother company may be rebutted by the private sector in consideration of specific documentation evidencing the absence of control or influence on the management body. However, this subjective appreciation may introduce further misalignment in the application of sanctions.

iii. General License expirations and scope; wind down periods; Dual-use goods

Clarity regarding wind-down general licenses have been helpful in allowing financial institutions to exit pre-sanctions relationships and transactions, and thereby mitigating the collateral effects of sanctions. However, challenges arise in jurisdictions with the absence of a wind-down period in the implementation of sanctions and where there are differing expiration dates and scope of general licenses. Clarifying the scope of the general licenses and their expiration dates, as well providing a simple consultation mechanism for specific licenses would help obviate these issues across jurisdictions.

Lastly, the financial sector is facing additional challenges in terms of expertise and increased volume of activity to accurately identify and flag relevant transactions involving dual-use goods. Most regulatory guidance (i) either describes dual-use goods in broad terms which does not assist in narrowing the models/materials of concern (ii) or is overly technical, requiring specific expertise. Furthermore, standardized goods codes are not always aligned and cannot easily be mapped with dual-use goods references, preventing their use for screening. Such issues should be further considered as sanctions regimes are coordinated both domestically and internationally.

b. Communication on Implementation

A key challenge for sanctions implementation and compliance is any lack of clarity and consistency in the communication of expectations regarding financial sanctions, particularly in relation to official guidance with cross-border implications. Insufficient guidance from relevant authorities (including on issues concerning possible circumvention techniques), along with guidance at supranational level which may then deviate from one implementing country to another, can lead to differing compliance interpretations and can cause adverse consequences for the efficacy of sanctions regimes. This can also impact businesses and customers of financial institutions which are not the intended targets of sanctions policy and can cause knock on effects for client relationships globally, particularly in the context of correspondent banking services.

These issues can lead to unintended consequences which conflict with the original policy goals of financial sanctions. Challenges can arise from the blanket de-risking of sectors or geographies, the reconsideration of requirements around knowing your customers' customer (KYCC) for compliance and risk management purposes², and the potential impact on sectoral trade impacting global supply chains. Unintended trade sanctions can also arise where there is lack of clarity on the interaction of financial sanctions with export controls or similar prohibitions.

Further consequences from this lack of clarity can be seen in an increase in operational issues for financial institutions and implementing authorities due to the high number of false positive matches for sanctioned entities, which can generate risk in the review of domestic and cross-border transactions. Questions also arise in relation to the extension of screening obligations to different stakeholders.

We recognize the significant efforts at communication undertaken by authorities during the implementation of sanctions regimes concerning the Russia/Ukraine conflict; however, not all communications regimes are necessarily as effective as

² There has been a longstanding focus by the Financial Action Taskforce (FATF) and national authorities on clarifying that the FATF standards do not require a "know-your-customer's-customer" (KYCC) approach to conducting customer due diligence. Please see: FATF Guidance; *Correspondent Banking Services*, October 2016 and FATF, *Dialogue with the Private Sector*, March 2015.

others. As such, greater coherence in communication and guidance at a multilateral level would help ensure greater precision in the implementation of sanctions which are designed in similar ways across multiple jurisdictions.

This should include coordination of timing on sanctions implementation, as noted above, but also timing on the release and substance of Frequently Asked Questions (FAQ) and how they apply across sanctions regimes and to third countries. At the outset of a wide-ranging sanctions policy response, there should be concerted efforts to provide one common communication on details in implementation between participating jurisdictions beyond regular high-level messaging.

Lastly, there should be active communications and coordination with the financial services sector globally concerning the design and implementation of new sanctions. Though we note the highly constructive activity taken by authorities and supervisors to respond to questions from stakeholders as financial sanctions were put place on Russia has been beneficial³, further direct opportunities for engagement should be considered as a matter of course in sanctions implementation. The organization of workshops with the financial sector beyond the usual consultation channels and greater coordinated engagement between jurisdictions on responses to questions from the financial services community on similar cross-border concerns would be valuable to the overall efficacy financial sanctions implementation.⁴

2. THE EVASION OF FINANCIAL SANCTIONS:

The means by which financial sanctions are evaded through the use of illicit financial methods is a core concern for the overall effectiveness of sanctions regimes. These issues are amplified by the cross-border nature of financial crime and disparities in effective application of anti-money laundering and countering the financing of terrorism (AML/CFT) standards globally⁵.

In the context of the Russia/Ukraine conflict, there are instances of financial flows and commercial trade directly and indirectly to jurisdictions where sanctions are not in place. The Russian economy is still benefiting from sales of oil and gas - and imports of controlled goods or services including technology and military imports - through the support of (i) countries without a targeted sanctions policy; (ii) nations considered political allies of Russia; (iii) countries dependent on Russian imports; (iv) countries/companies/individuals making use of alternative methods of financing and payments and/or (v) the utilization of money laundering and ancillary financial criminal means. Certain sanctioned entities are also benefiting from opacity in global beneficial ownership arrangements, even though global transparency standards are in place through the Financial Action Task Force (FATF).

The efficacy of financial sanctions can be enhanced through the coordinated closing of loopholes in sanctions circumvention methodologies, particularly as they relate to the wider issues of cross-border financial criminality and the enablers of illicit financial flows. As such, ensuring common high standards and collaboration in the following areas – alongside effective risk-based supervision and globally consistent reform where necessary - should continue to be considered:

- i. *Enhancements to Public/Private Sector Cooperation: Public/Private Partnerships (PPP) are a collaboration between financial institutions, law enforcement, policy makers and the regulatory community to tackle financial crime. They have increasingly become a critical and growing component in global financial crime frameworks. Not only are PPPs an important step in the ability to deliver operational benefits and efficiency gains, but they*

³ We note that beginning in February 2022, the IIF held a series of meetings with sanctions officials across implementing jurisdictions in coordination with our membership which proved extremely valuable, along with submitting written questions for review by relevant authorities on outstanding matters relating to implementation.

⁴ Guidance on sanctions evasion typologies or risk indicators is also useful and undertaken by some jurisdictions, though not always coordinated globally or widely communicated to international stakeholders.

⁵ Please see: FATF, *Report on the State of Effectiveness and Compliance with the FATF Standards*, April 2022.

can also provide a framework to build the relationships and dialogue between stakeholders to help coordinate and catalyze coherent improvements to the wider AML/CFT system.⁶

Enabling PPPs on a domestic and multilateral basis to share information concerning material financial crime matters linked to the evasion of financial sanctions will help complete the picture for compliance by financial institutions and enforcement by relevant authorities. Strategic as well as operational information sharing between the public sector and the financial services industry will ensure more targeted risk management and help alleviate concomitant issues with the design and implementation of sanctions noted earlier in this paper, such as unnecessary de-risking decisions or the application of unwarranted KYCC compliance methodologies.⁷

Another significant challenge for many financial institutions concerns resourcing. Given the particular complexity of the targeted Russian sanctions regimes in place, there is increased pressure on the financial sector to find and hire financial crime compliance professionals to meet the added demand. Enhanced cooperation with the public sector is one way to help target resources in the most effective manner possible as multilateral sanctions are contemplated and deployed.

- ii. *Sharing information within/between financial institutions and across borders:* The information flow within/between financial institutions for matters linked to money laundering, terrorist financing and other issues of financial criminality would also benefit sanctions policy compliance. We emphasize at the outset when discussing this issue that data protection and data privacy remain critical when dealing with the concept of sharing information. Whilst the protection of customer/personal data and the right to privacy are of unquestioned importance, the upholding of such principles with adequate safeguards is not mutually exclusive with exchanging information on illicit financial activity where necessary to limit its furtherance and identify means/methods/avenues of sanctions circumvention.⁸
- iii. *Common application of FATF standards for beneficial ownership transparency:* Identifying the true beneficial owner or individual exercising control in a business relationship is critical for both the public and the private sectors in the fight against international financial crime. Entree to current, reliable, verified, and accessible beneficial ownership information remains a global priority and this issue has been magnified by the role opaque beneficial ownership regimes can play in disrupting international sanctions in relation to the Russian invasion of Ukraine. Beneficial ownership data and the registries in which it is held are key to the understanding of ownership and control for implementation of financial sanctions.

Inconsistencies in national or regional approaches to beneficial ownership information reporting and access create significant barriers to effectiveness and impede the value and potential of information sharing for the purposes of detecting and preventing sanctions evasion. Alignment with standards at the FATF concerning Recommendations 24 and 25⁹ will help ensure common rules on transparency are applied to mitigate the concealment/diversion of sanctioned assets. Global harmonization will also help allow for greater interoperability in terms of access to beneficial ownership information ultimately kept in national or regional beneficial ownership registers.¹⁰

- iv. *Common application of FATF standards for virtual assets:* Though the current size of the global virtual assets market is insufficient to provide a channel for broad sanctions circumvention, financial sanctions by their very

⁶ For further information on PPPs, please see: IIF/Deloitte, *The effectiveness of financial crime risk management reform and next steps on a global basis*, November 2021.

⁷ For example, the Europol Financial Intelligence Public Private Partnership (EFIPPP) put in place a Circumvention of Sanctions Work Stream in relation to the Russian invasion of Ukraine. Such a multilateral PPP is a good example of targeted international cooperation on strategic information exchange.

⁸ For further information on information sharing, please see: IIF/Deloitte, *The effectiveness of financial crime risk management reform and next steps on a global basis*, November 2021.

⁹ The FATF Recommendations, Amended March 2022.

¹⁰ Please see: IIF, *Letter on the FATF R.25*, August 2022 and IIF, *Letter on FATF R. 24*, August 2021.

nature are complex and sanctioned entities often adapt to different evasion methodologies.¹¹ As such, countries should ensure alignment in implementation of the FATF standards and guidance on virtual assets and virtual asset service providers to prevent those seeking to evade financial sanctions from exploiting jurisdictions with weak or no supervision.¹²

- v. *Standards for non-financial businesses and professions:* To ensure gaps in sanctions enforcement are adequately addressed, it is important for policymakers to focus on the regulation and supervision of non-bank intermediaries or “gatekeepers” and the role they play in upholding and furthering the objectives of national and cross-border sanctions policy. Specifically, foundations and trusts, company formation agents, law firms and related gatekeepers may not always fulfill a sufficient duty of care in limiting the opacity of corporate structures. Closer attention by national and supranational authorities on activities by these entities which could contribute to the circumvention of sanctions is warranted, as is consideration of these issues at the FATF through revisions to FATF Recommendation 25 on the beneficial ownership of legal arrangements.¹³

Lastly, it is important to also be aware of potential unintended consequences from efforts related to the curtailing sanctions circumvention. Specifically, the risk of circumvention involves other unexpected side effects when jurisdictions consider the introduction of a new criteria designed to list or “freeze” persons circumventing sanctions. While the intent of such criterion may be efficient to fight against economic operators voluntarily seeking to facilitate circumvention, clarity may be missing in respect to the possibility for financial institutions to be erroneously added to such a list following an incident or an unwillful indirect participation in a transaction involving a circumvention.

Conclusion and Next Steps: Geopolitical threats will often be addressed by economic and financial sanctions going forward, and it benefits the wider global community if current and future sanctions regimes are shaped by sound practices on cross-border coordination developed through learned experience. Specifically, understanding which differences need to be applied across sanctions regimes dependent on security objectives, while at the same time recognizing those elements which may be transferable in the design and implementation of sanctions, will benefit the efficacy of the actions being taken to achieve the goals being pursued. This crucially includes continued and enhanced cooperation and communication across countries and with the private sector, additional efforts to address sanctions evasion and financial crime more broadly, and cross-border sanctions harmonization where practicable and necessary.

In order to foster a global dialogue on taking these issues forward, a great deal of benefit would be derived from the establishment of an international public/private sector forum on sanctions design and implementation and the prevention of sanctions circumvention. Such a forum would allow for regular cross-border discourse between key stakeholders across the G7 countries and beyond to foster greater public/private sector understanding on how sanctions can be most effectively established and deployed.

Such a forum will also help with work on how compliance can aid in achieving key objectives, whilst obviating challenges and unintended consequences. The IIF stands ready to engage with policymakers, regulators, law enforcement bodies, and our member institutions on building the model for such a framework.¹⁴ This would assist in addressing many of the issues raised in this paper specifically relating to divergences in prohibitions/lists of sanctioned individuals, sectoral application, the timing of designations across jurisdictions, and international communication on guidance. This, coupled with the link between sanctions implementation and the mitigation of sanctions evasion, will support current and future multilateral efforts for the application of economic security measures.

¹¹ IIF, *Macro Notes: Russia - Crypto Assets and Sanctions Avoidance*, June 2022.

¹² FATF, *Updated Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers*, October 2021.

¹³ FATF is currently considering changes to R.25 and its interpretive note. Please see, *IIF, Letter on FATF R. 25*, August 2022.

¹⁴ Similar initiatives have been built concerning financial crime risk management, including the Europol Financial Intelligence Public Private Partnership (EFIPPP), the first multilateral PPP which began through engagement between the IIF and Europol in 2017.