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New Frontier for Bank Secrecy Act Prosecutions: Trade-Based Money Laundering

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Since the September 11, 2001, terrorist attacks, U.S. law enforcement and financial regulatory agencies have focused on disrupting the use of the financial system by terrorist groups, criminal organizations and tax evaders to hide illicit funds. As part of these efforts, the Department of Justice (DOJ) and the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) have been increasingly scrutinizing anti-money laundering (AML) compliance efforts and pursuing domestic and foreign banks for violations of the Bank Secrecy Act. Because of this heightened enforcement environment and due to the tremendous recent growth of trade-based money laundering, financial institutions should expect a surge in government investigations, and potentially prosecutions, for failures to maintain adequate trade-finance AML compliance programs.

With an estimated 80 percent of the world's illicit money flow stemming from trade-related activities, AML regulators and prosecutors are progressively turning their enforcement focus to trade-based money laundering (TBML) and scrutinizing financial institutions' trade-finance compliance programs for potential AML violations. As authorities are continuing to take an increasingly tougher stance on banks' failures to comply with the Bank Secrecy Act (BSA), domestic and foreign financial institutions operating in the United States should promptly assess their TBML compliance policies and procedures and make improvements, where needed, in relation to their trade-related activities.

Prosecuting Bank Secrecy Act Violations

Pursuant to the BSA, financial institutions are generally required to maintain AML compliance policies and procedures, including, among other things, a system of internal controls to ensure ongoing compliance; comprehensive customer due diligence programs and account opening procedures; coordination and monitoring of compliance by a designated bank officer; independent testing of the compliance function by

internal or external auditors; adequate training for compliance and other appropriate personnel; and effective customer due diligence programs. In addition, under the BSA, banks must design and structure their AML programs to adequately address the risk posed by the products and services offered to the bank's customers, as well as the geographic locations in which the bank conducts business.

Generally, criminal penalties—such as fines of up to $500,000 and imprisonment of up to 10 years—can be imposed for violations of the BSA when a person, either an entity or individual, structures transactions to evade the BSA reporting requirements or willfully violates the requirement that financial institutions establish and maintain an adequate AML system. Additionally, federal banking regulators are authorized to bring civil monetary penalty actions against individuals as well as banks for violations of the BSA, and may seek to remove individuals from employment in the banking industry for violating AML requirements. Based on recently issued FinCEN regulations, such civil penalties may range from approximately $20,000 for certain recordkeeping violations to about $200,000 for willful violations of BSA requirements.

Over the recent years, U.S. law enforcement authorities have significantly increased their presence, investigations and prosecutions within the banking industry, and have been pursuing criminal and civil actions against an increasingly greater number of financial institutions for failures to establish AML compliance programs in accordance with the BSA. For instance, just last year, four of the five largest U.S. banks by asset size were subject to public enforcement actions addressing BSA compliance concerns. Moreover, as of July 2016, federal regulatory agencies have already imposed penalties exceeding tens of millions on banks and other financial institutions for failures to maintain adequate AML compliance programs. These numbers leave no doubt that BSA and AML compliance risk management must remain a focus of boards of directors and senior management of domestic and foreign financial institutions operating in the United States.

Trade-Based Money Laundering

Similar to traditional money laundering, TBML is the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to shield their illicit origins. While TBML schemes are generally quite straightforward and relatively simple, they are often difficult to detect because they are layered within the mass of legitimate payments flowing through the complex network of global trade. Generally, however, TBML techniques involve one or more of the following methods:

- Under-invoicing, where goods are invoiced at a price below their fair market value to enable the exporter to transfer value to the importer who will resell them in the open market;
- Over-invoicing, where goods are invoiced at a price above their fair market value to enable the importer to transfer value to the exporter;
- Multiple invoicing of goods and services, where more than one invoice is issued for the same international trade transaction, thus allowing a money launderer or terrorist financier to justify multiple payments for the same shipment;
- Over-and-under-shipment, where the quantity of goods shipped is overstated or understated in relation to the payment sent or received (including "phantom shipments," where no goods are shipped at all); and
- False description of goods, where a money launderer misrepresents the quality or type of goods, for instance by substituting an inexpensive product for the more expensive item listed on the invoice and custom documents.

As trade and the financial system have become extremely intertwined in today's global economy, it is imperative that banks be well equipped to combat the risks of trade-based money laundering. Indeed, with the growth of global trade and digitalization, banks must consider how to combine their processes, controls, data modeling and technologies to create a more effective TBML monitoring system.

Trade-Based Money Laundering Red Flags

Recent regulatory and criminal enforcement trends demonstrate the importance for financial institutions involved in the trade-financing business of implementing effective AML compliance policies and procedures to immediately detect and prevent TBML activities. While TBML schemes often involve multiple moving parts, potential TBML red flags generally consist of certain common indicators, including, among other things:

- Transaction structures that appear unnecessarily complex or involve the use of repeatedly amended or frequently extended letters of credit;
- Methods of payment that do not match the risk characteristics of the transaction;
- Transactions that involve front or shell companies or concern parties controlled by the same or related business entities;
- Inability by the bank's customer to produce invoices, bills of lading or other appropriate documentation to support a requested bank transaction;
- Shipments from jurisdictions designated as high risk for money laundering activities or trans-shipments of goods through one or more jurisdiction for no economic reason;
- Receipt of cash or other payments from third-party entities that have no apparent connection to the transaction or instructions to move cash somewhere else;
- Significant discrepancies between the description of goods on the invoice and the bill of lading, between the invoice or bill of lading and the actual goods shipped or between the goods' value as reported on the invoice and their fair market value;
- Anomalous shipment size in relation to the scale of the exporter or importer's regular or expected business activities; and
- Goods designated as a high-risk for money laundering activities such as consumer electronics or goods that are designated as dual-use technologies or products.

As regulators and prosecutors are expected to focus on the nuts and bolts of banks' TBML compliance programs, financial institutions involved in trade-financing should proactively evaluate how trade-finance transactions are monitored, how information is shared and what controls are in place to detect, escalate and report suspicious activity.

Implications for Financial Institutions

With ever increasing attention from regulators and prosecutors on AML compliance, it is important that financial institutions re-assess their approach to TBML risk and compliance. In particular, financial institutions involved in trade-finance activities such as issuing letters of credit, providing trade-supporting

loans to exporters or importers, or engaging in documentary collection, trade credit insurance, factoring or forfaiting should consider implementing TBML compliance programs to assess and mitigate money laundering and terrorist financing risks arising from trade-related activities. In particular, banks operating in the trade-finance business should, among other things:

- Adopt a risk-based approach to their customer due diligence obligations;
- Assess information such as product category, product description, unit prices and units to detect and prevent invoicing-based TBML;
- Perform trade control-specific customer due diligence, in addition to the general customer due diligence obligations, that include collecting customer information related to trade-based activities, updating customer due diligence information regularly, and obtaining further information where anomalies are identified (while documenting every step taken along the way);
- Implement policies and procedures for screening and alert handling in connection with trade-related activities that include methodologies to detect trade-based red flags, typologies, scenarios and sanctions, updating sanctions, terror and high risk jurisdiction lists, and monitoring dual-use goods;
- Establish transaction monitoring mechanisms to identify unusual or suspicious trade-based activities by applying a risk-based approach in light of the individual financial institution's trade-related products and services;
- Assure the adequacy of TBML transaction monitoring software systems and the proper training of personnel to use them;
- Design efficient internal reporting lines and processes to escalate suspicious reports to the financial institution's money laundering reporting officer; and
- Identify the appropriate staff to be trained and to act as trainers within the financial institution, and communicate about key issues specific to trade-related activities, including transactions and structures, typologies, emerging risks, case studies and red flags.

As U.S. prosecutors and regulators at the federal and state level are taking an increasingly aggressive approach to addressing AML risks and imposing larger and larger penalties for BSA violations, financial institutions involved in the trade-finance business must proactively evaluate their TBML-related AML policies and procedures to ensure that they are sufficiently robust to withstand a potential government inquiry.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the attorneys below.

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