Handbook of Anti Money Laundering
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1 WHAT IS MONEY LAUNDERING?

1.1 THE INITIAL CONCERNS

The growth industry which we refer to as money laundering has developed significantly over recent years. The industry really started with what might be considered a key public concern over organised crime and the negative impact that this was having on people. The governing authorities surmised that, by tracking the movement of cash, they would then be able to detect unusual patterns of behaviour. This led to a series of rules being put in place, originally locally but increasingly globally, to enable relevant authorities to identify organised crime through its use of the financial sector.

The key element that underpins the regulation is that inappropriate funds were being moved within the banking system to disguise the original source of the funds, enabling organised crime to make free use of funds that may have originated from tainted sources, including drug trafficking. Essentially, the plan was to use the movement of the gains to identify the criminal, since the original criminal activity was so hard to detect.

The impetus behind money-laundering legislation in any country always comes from some form of issue which is considered to be of such magnitude that it actually gets onto the political agenda. The legislation is then generally developed in a hurry to meet these perceived and specific needs. We are seeing this at present with the revised banking regulations, designed to try to prevent a financial crisis yet actually creating one of their own.

The initial drive to combat money laundering derived from the wish to reduce narcotic-related criminal activity. Much of the original legislation concentrated on narcotic-related issues, since this area was seen as being the primary concern. This initial legislation has now been extended in most countries to include terrorist financing and, more recently, to incorporate funds resulting from any form of illegal act. The definition of what is an illegal act does vary between countries and is likely to be broader than you might initially expect.

To take one area where there may be concerns, taxation-related matters are a particularly complex area for financial crime regulation. Tax avoidance is generally not illegal unless it is deemed abusive, whereas tax evasion is illegal. In cases where tax evasion has taken place, criminals have the use of the funds that should have been paid over as taxation and therefore these are funds relating to criminal activity. Any transaction relating to these funds will now be considered as money laundering. Changes in regulation and legislation that are currently being implemented are often designed to capture different elements of the abuse of the taxation system of the relevant jurisdiction and this has led to much of the recent growth in financial crime regulation.

As discussed, the consequence of the manner in which legislation has been enacted globally is that what are considered to be money-laundering predicate offences do vary considerably between countries. More recently there has been a significant effort to achieve a level of international standardisation within the money-laundering deterrence arena, led by groups such as the Financial Action Task Force (FATF) as discussed in Chapter 3, although they, of course, do not have any statutory responsibility. It remains the responsibility of the local legislature to implement the requirements into local law – and they will often take into account specific local issues and other existing legislation in doing so. This is particularly the case in respect of the USA, as discussed in Chapter 9, and is addressed in more detail in the various country profiles which conclude this text.

1.2 WHAT IS MONEY LAUNDERING?

The idea of money laundering is simple in principle. The person who has received some form of ill-gotten gains will seek to ensure that they can use these funds without people realising that they are the result of inappropriate behaviour. To do this they will need to disguise the proceeds such that the original source of the proceeds is hidden and therefore the funds themselves appear to be legitimate. Given that it is often cash that needs to be disguised, the criminal will often seek out legitimate cash-based businesses to enable them to disguise the source of their illegitimate cash.

When you are discussing the laundering of money, there are generally two different connotations to consider. Money laundering refers both to the use of a cash business such as a launderette to facilitate the mingling of legal and illegal funds and also to the generic process of disguising the original proceeds of the funds, a process more normally referred to as layering. By mixing legitimate and illegitimate funds, the entire amount could potentially appear to be legitimate, and would therefore have been laundered, achieving the objectives of the money launderer. The funds will appear to have come from the legitimate business whereas some of the funds actually have arisen from criminal activity of some type. Indeed, coin-operated launderettes, which are generally cash-based businesses, would represent an ideal opportunity to achieve this, and much early money laundering did make use of legitimate cash-based activity to disguise and transform ill-gotten gains.

If a business normally takes in cash of, say, £20,000 per week, would anyone notice if this increased to £25,000? The original £20,000 is clearly legitimate business that is being conducted, whereas the next £5,000 may represent funds from an inappropriate source that is being laundered through the medium of the legitimate business. It is hard for any financial institution to identify that a firm should have only banked £20,000 when in fact it banked £25,000, so this type of money laundering is actually very difficult to identify. The only approaches to addressing such issues are due diligence on the part of bank employees and modelling approaches which serve to select specific accounts warranting additional investigation. Of course, any investigation work must be undertaken without notifying the customer that they are under suspicion, as we shall discuss later.

It is important to recognise that there are two main styles of money laundering – professional and amateur. The professional money launderer will take advantage of any perceived weakness in the systems of control operated by a financial institution or regulatory structure. Amateur money laundering takes an opportunity and does not really cover its tracks very well, leaving obvious causes for concern which are easy to identify either by employees being diligent or through the use of modelling systems. It is normally the latter type of money laundering that is detected by law-enforcement agencies. The professional is always much harder, and therefore more expensive, to identify.

As discussed above, initially cash-based businesses were one of the key areas on which money launderers would concentrate to launder their funds. Returning to the business of a launderette, this is an obvious example of such a suitable vehicle for the money launderer. Anyone can walk into a coin-operated launderette and put their coins into the machine or pay the attendant for laundry services. The payments will predominantly be in cash and there can be very little control to ensure that the funds that would be banked by the launderette business are actually the same as those that are received by the launderette. This therefore achieves the objectives of money laundering – the use of the launderette business will enable a criminal to disguise the source of their funds so that they appear to be from legitimate sources and can be used freely.

Clearly, organised criminals are able to take advantage of any number of cash-based businesses to disguise illegal proceeds. The following are just a few of the types of business which have been subject to abuse by money launderers:

- Launderettes
- Newspaper sales
- Taxis
- Bars and fast food restaurants
- Casinos
- Insurance
- Asset management
- Antiques
- Property.

Some of the vehicles will not be used for the primary placement of cash but will become part of the layering process which is considered in more depth in the next chapter. Of course, as detection of money laundering has become more sophisticated, then so has the skill of the money launderer, giving rise to more complex ways of making use of the financial markets.

1.3 THE PROCESS OF MONEY LAUNDERING

Money laundering is essentially a three-stage process, as discussed in Chapter 2. It starts with the criminal activity that gives rise to the illegal funds. We have mentioned drug-trafficking offences, but everything from tax evasion to bribery and corruption results in funds being produced which the criminal will seek to disguise. The funds need first to be received and then introduced into the system. It is often at this first introduction phase that the detection authorities have their best chance of identifying the funds as being inappropriate, leading to potential criminal prosecution. This stage is then followed by the layering and integration phases.

Clearly, a series of fees and costs will need to be incurred by the launderer to achieve their objective of disguising the original source of the funds. It is the combination of the level of criminal activity in the world with the level of fees that may be earned that results in money laundering being such a lucrative industry. Of course, as the money launderer becomes more sophisticated, it is also incumbent on the financial intermediaries (banks, brokers, insurers, casinos and other entities) together with law-enforcement agencies to become more sophisticated and vigilant in their deliberations. This tends to result in new legislation being implemented to deal with what is the last problem that has been identified – whether it actually reduces money laundering is, of course, another matter. While we still have activities that we consider to be criminal, we will have criminal proceeds and consequently money laundering to contend with.

1.4 THE PRIMARY OFFENCES

Initially, the drive of the money-laundering-deterrence legislation was to restrict and identify the activities of organised criminals and gangs. This was then extended to the area of narcotics and drug trafficking – indeed much of the current legislation has drug-trafficking prosecution at its heart. The idea is that by making it difficult for the syndicate that is producing the narcotics and then distributing them around the world to make use of the funds generated, there will be a reduction in the level of narcotics that are available and therefore drug taking will reduce. Of course, for this to be the case the penalties under the legislation and the likelihood of being detected must be higher than the expected benefits from the narcotics trade. Whether this is actually the case is open to debate and could be one of the reasons why the narcotics trade does not appear to be diminishing.

In more recent years terrorist financing has also become a major cause for concern, and again money-laundering deterrence has been targeted as one of the ways in which the authorities within a country can be seen to be acting to attempt to reduce the ability of such organisations to act within a specific jurisdiction.

So, the three original key areas where money-laundering-deterrence legislation and regulation were intended to be effective were:

- Organised crime
- Drug trafficking
- Terrorist financing.

Each of these is a clearly illegal activity in most countries, although they are not always easy to define completely or accurately. More recently in many countries the scope of such rules and regulations has broadened significantly, effectively becoming what might be considered "all crimes" legislation. This clearly results in a broadening of the areas of criminal activity being covered by such legislation, which would include some or all of the following:

- Robbery or theft
- Blackmail or extortion
- Bribery and corruption
- Piracy of various types
- Illegal pornography or issues related to sexual matters
- People trafficking
- Tax evasion.

1.5 DUE DILIGENCE

The role of the financial institution is to be diligent and to act when it becomes suspicious. Whilst in the case of tax evasion the suspicion may not immediately be obvious to people involved with managing the account at the financial institution, in other cases it will be. It is therefore important for financial institutions and other relevant entities to identify their customers and associates properly, undertaking what are referred to as due diligence procedures, or, if they are relationships that are identified as having a high perceived risk, undertaking enhanced due diligence procedures.

Such a due diligence process begins with procedures whose objective is the identification of the customer or associate as an appropriate person for the firm to do business with. This will involve obtaining information on both people and companies and their source of funds as required by local regulation and the policies and procedures of the firm.

This, of course, relies on the staff of the financial institution undertaking their roles with care and this can be difficult. Banks want to sell financial service products to their clients. If a client comes to a bank and wants to open a bank account, the bank needs to obtain the information it requires to comply with the regulations while at the same time selling to the customer. If staff begin to see the financial crime regulatory requirements as little more than a regulatory construct, they will not remain as vigilant as should be the case and the money launderer will become a customer.

Continual training is required to constantly emphasise the importance of the controls applied by the bank. Only through the first line of defence of the bank, the front-office staff, exercising careful due diligence can a firm really be protected.

After taking on the initial relationship, the requirement to undertake due diligence does not end. The financial institution will still be required to undertake monitoring of the customer to see that the activities undertaken appear to be consistent with their understanding of the customer and are not suspicious. This ongoing due diligence obligation will continue throughout the customer relationship and will again be enshrined in local regulation and the policies and procedures of the firm.

If a suspicion has been identified, it needs to be investigated by the financial institution to ensure that there are real grounds for suspicion. The requirements in this respect are generally included in local regulation, transposed into the rules of the firm. Only once the transaction has been investigated should the suspicion be reported to the relevant authorities by the relevant officer at the financial institution, a role normally referred to as the Money Laundering Reporting Officer (or MLRO). The suspicious activity report (or SAR) submitted to the relevant authority will potentially document that the financial institution has met its obligations under the relevant legislation, providing a safe harbour from prosecution. It will also provide the enforcement authorities with another link in what might be a lengthy chain of reports which could lead to a successful prosecution.

1.6 THE EVASION OF TAXATION

There are few things more certain in life than taxation, unless you are lucky enough to be based in a jurisdiction where no taxes are, in fact, payable – certain countries in the Middle East, for example.

In most countries, some or all of the following taxes apply:

- Income tax
- Corporation tax
- Sales tax or Value Added Tax
- Inheritance tax
- Capital gains tax
- Local sales tax
- Car tax
- Petroleum revenue tax
- Gaming duty
- Alcohol duties
- National insurance
- Property taxes.

With such a range of possible taxes available that both individuals and businesses could be subject to, it is hardly surprising that an industry has emerged to assist individuals and corporations in minimising the amount of taxation that they are required to pay.

When you are organising your affairs to minimise the taxation that will be levied, this is clearly a legal process unless you are based in a country that has implemented abusive taxation avoidance legislation. Generally, the failure to pay taxation that is due and payable is clearly a criminal offence and therefore would be covered by “all crimes” money-laundering-deterrence rules and regulations. The problem is that taxation statutes and their legal interpretation are generally far from certain and therefore court action is often required to enable the legal position to be clarified with any degree of certainty.

To illustrate the problem, consider the following. A company is seeking to acquire another business. At the time when a transaction was entered into to buy the company, the acquired business may have thought that what it was doing was legal, and therefore that it was paying the correct sums of taxation to the relevant collecting authority. It may only be after the case has been resolved in favour of the taxation authorities that the firm would have been guilty of money laundering, since it would have failed to pay the appropriate amount of taxation on the due date. The firm that has purchased the business then has concerns in that it may have overpaid for the company it has acquired.

Of course, such a case would tend to focus on the economic reality of the situation as opposed to money laundering, which is really not a concern, since there was no such intention in the activity. It is cases where there is a lack of clarity in taxation legislation that tend to prove problematic and it is when the company is taking actions to minimise taxation which are perhaps pushing the boundaries that problems occur.

Tax havens are financial centres which offer a range of services to international businesses and individuals to reduce or eliminate their home country taxation liability. For some time now, and particularly since the economic crash of 2008, there has been significant global financial and political impetus to clamp down on tax havens. With the objectives of both preventing financial crime and ensuring the full amount of revenue is received by the exchequer, countries such as Switzerland and Luxembourg have come under increased scrutiny as their financial privacy laws are being eroded. This is likely to lead to the discovery of a number of questionable, if not illegal, schemes which were previously protected by the renowned privacy laws of the havens, while encouraging criminals to devise new and more advanced schemes to evade the uncovering of their frauds once again.

Difficulties arise when a scheme which was thought to have been legal becomes illegal, something that can easily occur where there is tax planning taking place. In such cases, the funds which were once legal have now become illegal and therefore will be subject to the financial crime regime.

1.7 SUSPICION AND REPORTING

The key issue is that actions taken by firms to attempt to reduce the level of their taxation may eventually be seen as being too extreme and therefore could potentially be considered as being illegal. If a country adopts an “all crimes” approach to money-laundering deterrence, then there may be a requirement for such matters to be reported immediately to the reporting authorities in cases where there clearly is a suspicion. Of course, the point at which the suspicion occurs may itself be unclear.

A suspicious activity report (or SAR) will typically then be provided to the relevant in-country authority for them to consider whether action should be taken. In many cases, the authorities will not have sufficient information to take action, in which case nothing will happen. In other cases, they will link information from the single SAR with other SARs that they receive, leading to information linking investigations and ultimately to criminal prosecution.

1.8 THE LOCAL SERVICE PROVIDER

Do you personally have any local service providers that you pay in cash? This might include plumbers, carpenters, gardeners, taxi drivers, builders and similar parties. Would you expect that person to disclose all of their income to the relevant taxation authorities? Is it possible that they may choose to show a lower amount of revenue than is actually the case to reduce the amount of taxation that would be due and payable? This is clearly a plausible scenario, but is it sufficient to result in the money-laundering-deterrence regime applying and a SAR being produced?

Generally, such activities are, to some extent, not included within this form of legislation. Basically it would not be helpful for financial institutions and others to report cash-based businesses to the relevant authorities purely because they were cash-based businesses. Just because it is possible for the activity to permit tax evasion, does not mean that there actually will be tax evasion and therefore, generally, this cannot be sufficient to result in a suspicion of money laundering and consequent reporting to the approved party. However, if there is a clear suspicion, then such reporting should still take place.

Could there also be obligations on a financial institution regarding the under reporting of income or some other form of tax evasion? The answer is clearly yes. If the firm should have been aware that the firm was under reporting its income or in some other way evading taxation unlawfully, then this would be a reason to report the firm to the relevant authorities and for the money-laundering-deterrence legislation to apply.

However, since the financial institution may not be the only firm with which the customer is undertaking banking activity, the ability of the single firm to identify such cases is limited.

1.9 LICENCE PAYMENTS

In some countries it will be illegal to drive without a driving licence, or to operate a specific car without the vehicle having been approved, or to have a television without the relevant approval. Such areas are generally seen as being too minor to warrant investigation by relevant authorities and are therefore generally seen as more minor offences. Accordingly, retaining the funds that you should have paid for the licence will not, in itself, mean that you are guilty of money-laundering offences in addition to the original offence resulting from failure to have the licence.

What this means is that, as you move from one jurisdiction to another, it is always important to make sure that you are fully aware of what the predicate offences are within the specific jurisdiction that you are involved with. It is also important to stress that some jurisdictions include an element of extraterritorial provisions, enabling the regulator in one country to take an interest in payments in another country, with the USA being one obvious such case, as set out in Chapter 9.

Of course, tax evasion is not at the heart of the money-laundering-deterrence regime, yet it is increasingly one of the major areas where such legislation is applied. Understanding the local regulatory requirements for due diligence, monitoring and reporting, training staff adequately and rigorously applying relevant procedures is always the best protection for any firm in any jurisdiction.