7

Setting Financial Sector Obligations

7.1 The General Requirement

While the basic statutory money laundering offences and defences, for example the requirement not to assist any other person to launder the proceeds of crime, will apply universally, additional measures are necessary to strengthen the financial sector against abuse by money launderers. FATF Recommendation 19 states:

> *Financial institutions should develop programs against money laundering. These programs should include as a minimum:*
> *(i) the development of internal policies, procedures and controls, including the designation of compliance officers at management levels, and adequate screening procedures to ensure high standards when hiring employees;*
> *(ii) an ongoing employee training programme;*
> *(iii) an audit function to test the system.*

7.2 Defining Financial Sector Activities

The following activities to be covered as a minimum are set out in the Commonwealth Model Law and combine the activities listed in the Annex to FATF Recommendation 9 and those listed in the Vienna Convention:

- ❖ lending (including personal credits, mortgage credits, factoring with or without recourse, and financing of commercial transactions, including forfeiting);
- ❖ finance leasing;
- ❖ venture risk capital;
- ❖ money transmissions services;
- ❖ issuing and administering means of payment, for example credit cards, travellers' cheques and bankers' drafts;
- ❖ financial guarantees and commitments;
- ❖ trading for own account or for account of customers in:
  - (a) money market instruments (cheques, bills, Certificates of Deposit, etc.)
  - (b) foreign exchange
  - (c) financial futures and options
  - (d) exchange and interest rate instruments
  - (e) transferable securities;
- ❖ underwriting share issues and the participation in such issues;
- ❖ money broking;
- ❖ investment business;
- ❖ deposit taking;
- ❖ insurance business transactions;
- ❖ real property business transactions;
- ❖ bullion dealing;
- ❖ casinos and other gambling and betting services;
- ❖ financial intermediaries.

7.3 Defining the Financial Sector

The FATF Recommendations recognise that professional money launderers do not confine their activities solely to the traditional banking sector. In particular, as the banking sector strengthens its controls against money laundering, the criminals will look for other avenues through which to place their ill-gotten gains indirectly into the financial system.

Recommendations 8 and 9 state:

> *Recommendations 10–29 (Financial Sector Obligations) should apply not only to banks, but also to non-bank financial institutions. Even for those non-bank financial institutions which are not subject to a formal prudential supervisory regime in all countries, for example bureaux de change, governments should ensure that these institutions are subject to the same anti-money laundering laws or regulations as all other financial institutions and that these laws or regulations are implemented effectively.*
>
> *The appropriate national authorities should consider applying Recommendations 10–21 and 23 to the conduct of financial activities as a commercial undertaking by businesses or professions which are not financial institutions, where such conduct is allowed or not prohibited. Financial activities include, but are not limited to, those listed in the attached Annex. It is left to each country to decide whether special situations should be defined where the application of money laundering measures is not necessary. For example, when a financial activity is earned out on an occasional or limited basis.*

However, beyond the traditional banking sector, there is no general definition of financial institution. It is therefore important that each Commonwealth country defines the scope of its financial sector broadly enough to cover all the types of commercial activity that might be considered particularly at risk from being used by money launderers.

Several of the relevant financial sector activities listed in paragraph 7.2 above may be conducted outside the formal financial sector, for example by unlicensed cash remitters, bureaux de change and in some cases casinos. It is important that all those conducting relevant activities are covered by the financial sector regulations.

Lawyers and accountants should also be included when handling client funds, acting as financial intermediaries or setting up companies and structures. Likewise, all the activities of corporate service providers and company formation agents should be covered. FATF Recommendation 25 states:

> *Countries should take notice of the potential for abuse of shell corporations by money launderers and should consider whether additional measures are required to prevent unlawful use of such regimes.*

7.3.1 Displacement

Experience indicates that where money laundering legislation is applied only to part of the financial sector, laundering activity quickly shifts into those areas where the legislation does not apply. This process is known as displacement. In particular, the activity will often be displaced from the formal financial sector into the informal sector and parallel economy (see Chapter 5). Displacement will also occur out of the financial sector into other areas, such as retailing, arts or antiques, where cash is accepted in settlement. The scope of anti-money laundering regulation must therefore be kept under review and the requirements extended to other business sectors as the need arises.

7.4 Financial Sector Regulations

As stated in paragraph 7.1, specific financial sector regulations are required to underpin the general criminal law. The regulations should require the financial institutions and businesses concerned to establish and maintain specific policies and procedures to guard against their businesses and the financial system being used for purposes of money laundering.

7.4.1 The Purpose and Scope of the Regulations

In essence, financial sector regulations are designed to achieve two purposes: firstly, to enable suspicious transactions to be recognised as such and reported to the authorities; and secondly, to ensure that if a customer comes under investigation in the future, a financial institution can provide its part of the audit trail.

To comply with the FATF Recommendations, the financial sector requirements should cover:

- the implementation of policies and controls;
- identification and know-your-customer procedures;
- record keeping requirements;
- measures for the recognition of suspicious transactions;
- reporting procedures for suspicious transactions and possibly currency transaction reporting;
- awareness raising, education and training of relevant staff.

When determining controls and procedures, and indeed when drafting legislation, it is essential that supervisory authorities bear in mind that relatively simple requirements which are easy to fulfil are much more likely to be accepted and followed than cumbersome requirements which place excessive demands on financial institutions and their staff. Wherever possible, financial sector requirements should simply be an extension of the due diligence already practised within the financial sector.

7.4.2 Implementation of Policies and Controls

A sound anti-money laundering and crime prevention strategy must emanate from board and senior management level. Senior management should therefore be made fully accountable for their institution's compliance with the financial sector requirements.

While the board must retain collective responsibility for setting overall policy and compliance, it is generally found to be valuable for the board to appoint a senior manager as the central point of contact with the authorities, particularly in respect of the reporting of suspicious transactions. This person is generally referred to as the Money Laundering Reporting Officer (MLRO) and, depending on the size of the institution, may also be responsible for overall anti-money laundering compliance.

To ensure that the board does not pass its collective responsibility for compliance to the MLRO, or some other designated person, it can be useful to require financial institutions to prepare an annual report setting out how they have met their anti-money laundering obligations, including the requirement to report suspicions. These annual reports can then be made available to financial sector supervisors as and when required.

7.4.3 Establishing Identification and Know-Your-Customer Procedures

FATF Recommendation 10 states:

> *Financial institutions should not keep anonymous accounts or accounts in obviously fictitious names. They should be required . . . to identify on the basis of an official or other reliable identifying document, and record the identity of their clients, either occasional or usual, when establishing business relations or conducting transactions.*

Customer identification serves two purposes. The first is to provide an audit trail for investigators pursuing money laundering operations. If financial transactions can be linked to individual account holders, it is possible for law enforcement authorities to put together an effective case when they wish to prosecute criminals and confiscate the proceeds of their crimes. Every failure to seek and record true identity makes it easier for criminals to retain their money.

Effective customer identification procedures serve a second purpose, in that they will make it difficult for criminals to use financial institutions. Where individuals are required to provide evidence of their identity, criminals have the choice of:

- having their true identity recorded (which leaves them open to greater risk of capture, conviction and confiscation);
- using false identification documentation, (which may be spotted by staff in financial institutions, leading again to capture and conviction);
- using intermediaries to conduct the transactions or open the accounts on their behalf (which raises the costs and increases the risks of detection).

The only alternative for determined launderers is to use non-financial institutions, which are clearly less well suited to their purposes. Again, the costs are increased and the risk of detection is higher.

Experience in many countries has been that the introduction of identification and record-keeping procedures has benefited financial institutions. The requirement to identify their customers has empowered the institutions to obtain information that assists them in their risk management procedures, without deterring customers who now know that they would be asked the same questions in any other institution. At the same time, legitimate customers who are aware of the legal responsibilities placed on financial institutions are more willing to provide information to the institutions. Knowing enough about customers and their legitimate business activities forms the basis for recognising suspicious arrangements and transactions.

Setting the Mechanism for Identification Evidence

Customer identification has become one of the most important aspects of an anti-money laundering strategy and the requirements can be complex. The obligations placed on financial institutions must therefore be capable of being met by a conscientious institution in a practical way. Where best practice can be applied, the objective should be to require identification of both name and address separately from official documentation or sources.

Different countries take varying approaches to the documentary evidence required. In those countries where there exists a national identity card system, that card is specified in legislation and regulation as providing the basis for identification. In other countries, which do not have such a system, no one particular document is specified, and financial institutions must determine their own approach based upon available documentation and records; such institutions often establish proof of identity by conflating various sources.

Many Commonwealth countries do not have a national identity card system, and in a number of countries the proportion of the population having formal photographic documentation confirming their identity may be as low as 5 per cent. It is therefore necessary to devise an approach that will ensure an adequate degree of customer identification, without denying access to the financial system to those who have no formal identification documents.

As part of their financial and economic reforms, some Commonwealth countries have sought to increase the proportion of the population subject to some form of official identification, in order to combat electoral fraud and to improve the efficiency of tax collection. Where possible, other grounds for requiring identification – including tackling money laundering – should be taken into account in administering this identification process. Ideally this would extend to the inclusion of a photograph on the identification document, but failing that the signature of the person to be identified would be acceptable, assuming that those wishing to open accounts and undertake transactions have basic literacy. If financial institutions were allowed access to a register of names and addresses, this would also assist in confirming that customers presenting such identification were who they claimed to be.

Where no system of identification extends to the majority of the population, it may be appropriate for identification procedures to be concentrated where there is the greatest risk of money laundering. At the most basic level, this would be where the sums of money involved were large or involved hard currency, or where there was movement of money in and out of the jurisdiction.

By and large, those individuals with large quantities of money are more likely to have formal identification documents, such as passports or driving licenses, and to have their address registered for official purposes. The same is likely to be true of those customers who handle foreign currency or make transactions involving other countries.

For those countries where wide-scale identification is not possible, it might be reasonable to require identification from customers conducting transactions over a certain size, or who hold accounts that may exceed a certain limit. Identification should also be required for all foreign currency accounts and for all transactions over a certain amount involving the transmission of funds into or out of the country. However, such an approach is less satisfactory than one involving comprehensive customer identification and will not meet international standards.

Where international best practice cannot be achieved at the outset, it will be necessary for financial sector supervisors and law enforcement agencies to monitor the effectiveness of the procedures and to introduce enhanced requirements as circumstances permit or the need arises.

Corporate Identification

A significant proportion of criminal money is laundered through the accounts and vehicles established on behalf of private companies or trusts and identification procedures are therefore extremely important. FATF Recommendation 10 goes on to say:

> *In order to fulfil verification requirements concerning legal entities, financial institutions should, where necessary, take measures:*
>
> *(i) to verify the legal existence and structure of the customer by obtaining either from a public register, or from the customer, or both, proof of incorporation, including information concerning the customer's name, legal form, address, directors and provisions regulating the powers to bind the entity;*
>
> *(ii) to verify that any person purporting to act on behalf of the customer is so authorised and identify that person.*

Private companies are particularly vulnerable to being used for money laundering and a full range of identification measures should be required, including the personal identification of principal shareholders and directors.

Companies listed on a regulated stock exchange are less vulnerable to being used for money laundering because of their public accountability. Identification of principal shareholders and directors is not therefore necessary. However, such companies are not immune from many of the underlying criminal offences such as fraud, bribery or corruption. Individual employees may also use the company's name as a smokescreen to mask illegal activity. Consequently, in the case of listed companies, identification of the company's representative is a vital requirement.

Identifying Underlying Beneficial Ownership

The ultimate objective of any anti-money laundering strategy must be take the profit out of crime. To be able to confiscate the proceeds of any crime, the beneficial owner must be identified and located. In many cases, the true owners of criminal funds will attempt to conceal their identities behind nominees or other people acting on their behalf.

FATF Recommendation 11 therefore states: *Financial institutions should take reasonable measures to obtain information about the true identity of the person on whose behalf an account is opened, or a transaction conducted, if there are any doubts as to whether these clients or companies are acting on their own behalf, for example, in the case of domiciliary companies (i.e. institutions, corporations, foundations trusts, etc., that do not conduct any commercial or manufacturing business, or any other form of commercial operation in the country where the registered office is located).*

Seeking the identity of the underlying beneficial owner can be of particular importance in the case of an offshore trust or an IBC where ownership is masked by nominee directors. (Identification and Know-Your-Customer Procedures are dealt with in more detail in Chapter 10.)

7.4.4 Recognition and Reporting of Suspicions

In order for a national strategy to succeed, it is essential that financial institutions (and within them individual members of staff) are required to report any knowledge or suspicion of money laundering in a timely fashion.

While the legal situation protects financial institutions from civil action by clients or liability for breach of confidence, it does not by itself defend them against the reputational damage that might arise if a disclosure, made in good faith but not relating to actual criminal activity, were to become known to the customer to whom it related, and that customer made the fact public.

To ensure that reports of suspicions are handled swiftly and confidentially, there must be a clear chain of responsibility both within individual institutions and continuing up through the authorities, so that individuals and institutions know exactly where they should take their information. Legislation should acknowledge that once employees have reported internally, they have fully met with their obligations.

These institutional arrangements should ensure that suspicion disclosures are only handled by a small number of people, all of whom are well trained and aware of the sensitive nature of this information. The Money Laundering Reporting Officer should be the key figure in this reporting chain and the link with the financial investigators.

Regular and direct contact between financial institutions and the authorities responsible for handling suspicion disclosures should increase the confidence that financial institutions have in the handling of disclosures, and will also tend to help the investigators and central authorities to understand the concerns of financial institutions.

While anti-money laundering legislation requires the co-operation of the financial sector in order to be effective, it is not the purpose of such legislation to turn financial institutions into detectives. Financial institutions cannot be expected to invest a large amount of time and resources in investigating their own customers' affairs to ensure that they are not laundering money. On the other hand, it is important that financial institutions do not wilfully turn a blind eye to what their customers are doing. Striking the right balance is something that will only come with experience.

It is important that institutions do not feel pressured into making 'defensive' disclosures (i.e. reporting to the authorities on the merest hint of an unusual transaction), but rather have the confidence to make the necessary commercial enquiries to confirm the substance of the suspicion. Legislation should permit the reporting of suspicions after the transaction has been undertaken, and should accept legitimate enquiries as reason for delay.

(Recognition and Reporting of Suspicions are dealt with in more detail in Chapters 8 and 11.)

7.4.5 Record-Keeping Requirements

Financial sector records provide a vital part of the audit trail in criminal investigations. The ability to track criminal money through different financial institutions across different jurisdictions and to identify the final structures, accounts or investments into which the criminal money is placed is essential, if the funds are to be confiscated.

FATF Recommendation 12 states:

> *Financial institutions should maintain, for at least five years, all necessary records on transactions, both domestic or international, to enable them to comply swiftly with information requests from competent authorities. Such records must be sufficient to permit reconstruction of individual transactions (including the amounts and types of currency involved if any) so as to provide, if necessary, evidence for prosecution of criminal behaviour.*
>
> *Financial institutions should keep records on customer identification (e.g. copies or records of official identification documents such as passports, identity cards, driving licences or similar documents), accounts fees and business correspondence for at least five years after the account is closed.*
>
> *These documents should be available to domestic competent authorities in the context of relevant criminal prosecutions and investigations.*

Format of Records

The format in which the records are to be retained needs to be determined in accordance with requirements for the admissibility of evidence in court proceedings. Timely retrieval of all records should also be required. (Record Keeping is dealt with in more detail in Chapter 12.)

7.4.6 Awareness Raising and Training of Staff

Properly trained and motivated financial sector staff provide the first line of defence against money laundering. Financial institutions should be required to take steps to ensure that all relevant staff are aware of their statutory obligations, their employers' procedures for guarding against money laundering, the need to recognise and report suspicions and the risks of becoming involved with criminal money.

Commonwealth countries will need to determine whether financial institutions should be required to test the competence of their staff and the extent to which the institutions themselves will be held responsible for negligent or wilful acts of their employees.

(Awareness Raising and Training is dealt with in more detail in Chapter 13.)

7.5 The Role of the Supervisory Authorities

Whether or not a single body is given responsibility for ensuring compliance with all aspects of anti-money laundering legislation, it is vital that a number of functions are carried out. These include:

- ensuring financial institutions comply with the requirements;
- providing a level playing field;
- ensuring that financial institutions do not fall under the control of criminals or criminal organisations;
- issuing guidance notes to assist financial institutions in meeting their obligations under the legislation;
- providing training for the staff of financial institutions in appropriate systems to forestall, prevent and recognise money laundering.

7.5.1 Monitoring Compliance

While it is clearly the responsibility of each institution's management to comply with legislative and regulatory obligations, it is also necessary for the appropriate supervisory authority to ensure that institutions have in place systems that address the requirements of FATF Recommendations 10–19, and the national legislation and regulations.

The supervisory authority responsible for fulfilling this requirement may need to inspect financial institutions' records and, if necessary, interview their staff. Financial supervisors and Central Banks will often have such powers. Even where these authorities do not have primary responsibility for tackling money laundering within the financial sector, they may have an interest in any finding that a financial institution is not taking adequate steps to guard against money laundering, as this may give cause for concern in other contexts. In order to maximise the effectiveness of such inspections, while minimising the burdens imposed by the inspection process on financial institutions, where responsibilities lie with more than one agency it may be appropriate for one authority to conduct inspections on behalf of others. This will require close co-operation between all the agencies concerned.

7.5.2 Using Licensing to Prevent Criminal Control of Financial Institutions

It is generally assumed that financial institutions themselves recognise the desirability of co-operating with the authorities to ensure that they do not find themselves inadvertently doing business with criminals. In almost all cases this assumption is justified, and financial institutions genuinely do want to 'keep the crooks off the books'. However, this is not the case where financial institutions have been set up by, or subsequently fall under the control of, criminals or criminal organisations.

A financial institution that knowingly launders criminal proceeds, and then conceals this behaviour from the authorities, poses a severe threat to the entire financial sector, and offers criminal organisations the best prospect of accessing the sector without detection. Unsurprisingly, this has tempted criminal organisations in some countries to make active efforts to acquire control of financial institutions which, in themselves, can lead to banking crises in the centres concerned.

It is essential that financial regulators and other authorities responsible for combating money laundering take steps to ensure that criminal organisations cannot take control of, or set up, banks or other financial institutions. The key to this is to ensure that applicants for licences to run financial institutions are adequately scrutinised to ensure that they are 'fit and proper' to conduct the business that they propose and that legitimate financial services business is actually conducted. Indeed, countries could consider imposing an ongoing 'fit and proper' test to be applied to all directors and controlling interests in financial institutions. The existence of brass plate banks and/or banks whose capital is issued in the form of bearer shares will offer prime opportunities for the criminal money launderer.

7.6 Establishing Partnership and Commitment

As stated previously, an effective anti-money laundering strategy requires a partnership approach. This must extend to a partnership between the supervisory authorities and the financial institutions. The legislators and regulators cannot provide an effective system without the goodwill and active co-operation of the companies and businesses concerned. Lack of consultation with the financial sector itself can often result in requirements that are unworkable and are therefore ignored. The supervisory authorities should be easily approachable and accessible to deal with the problems that will arise and should be prepared to bridge the gap between the financial institutions and law enforcement agencies.

Information and guidance about money laundering prevention and compliance should be clearly written and freely available, so that institutions are not thwarted in their attempts to tackle the problem and comply with legislation. The expectations of the supervisory authorities should be clearly communicated to all concerned to ensure that a level playing field is maintained across the whole of the financial sector.

The provision of financial sector guidance notes and training packages can assist in establishing a level playing field, thereby ensuring that all institutions are basing their strategies on a standardised approach and that the problems are put into context.

7.6.1 Providing Guidance Notes

It has been the experience of financial institutions in many countries where anti-money laundering legislation has been introduced that compliance with the legislation is made easier by the provision of officially approved guidance notes. In some countries, such guidance notes may have been developed by appropriate government agencies or supervisors, while in others the task has been allotted to industry bodies.

Whoever is responsible, it is important that such guidance is:

- ❖ accurate, reflecting the legal provisions in such a way that financial institutions can trust the guidance;
- ❖ comprehensible, so that it is easy to use;
- ❖ kept up-to-date, so that it reflects any amendments to legislation, practical experience or changes in the market place.

For these reasons it is desirable for the drafting of guidance notes to involve not only the regulatory and law enforcement agencies responsible for supervising and operating the legislation, but also the financial institutions themselves.

The guidance notes can provide a succinct explanation of the institutions' obligations under the legislation, and should set out good practice in complying with the law in a more detailed way than is possible in the text of the legislation. They should also give examples of what might be considered suspicious transactions, and what elements might be appropriate for inclusion in staff training programmes.

Compliance with the guidance notes should not be mandatory. They are for guidance, not cast in tablets of stone, and every financial institution should exercise judgement about how they can best meet their responsibilities. However, compliance with the guidance notes should be capable of providing an institution with a safe harbour in the event that their procedures are questioned by a supervisor or court, and any variations on them should require justification. Guidance notes can also provide a means of reacting quickly to changes in circumstances and market developments in a way that provides flexibility without obstructing desirable financial sector developments.

Section III provides additional guidance on financial sector procedures from which each jurisdiction can develop its own guidance notes.

7.6.2 Education and Training

While guidance notes form an invaluable adjunct to anti-money laundering legislation, they work best when combined with relevant training for the staff of financial institutions. While it is appropriate for financial institutions to train their own staff, it is vital that those officers who are responsible for making suspicion disclosures, and who therefore liaise with the supervisory authorities, receive sufficient training in their specific responsibilities. Such training is best provided in close association with those agencies responsible for the operation of the legislation.

Anti-money laundering training should cover a range of topics, in particular:

- ❖ the requirements placed on financial institutions under the legislation, including the duties to identify customers, keep records and train staff in the appropriate systems, as well as reporting suspicions;
- ❖ recognition of transactions which might relate to money laundering;

- ❖ determining to what extent suspicions that cannot be validated might be filtered out and not passed on to the authorities;
- ❖ understanding the sort of information that would be of value to the authorities, the extent to which follow-up information might be valuable, and what level of feedback might be expected in response to disclosures.

In some Commonwealth countries, the provision of training has been arranged in association with the financial sector trade associations, who have been able to devise appropriate manuals and materials for training staff at all levels within financial institutions. This approach has helped to develop mutual understanding between the authorities and the trade associations, which has allowed the effectiveness of the legislation to be monitored informally, and possible improvements to it to be identified at an early stage.