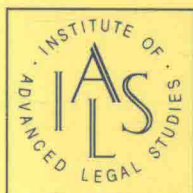


STUDIES IN
COMPARATIVE CORPORATE
AND FINANCIAL LAW

Criminal Finance

The Political Economy of Money Laundering in a Comparative Legal Context

Kris Hinterseer



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PhD, MA Cantab



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Dedicated to

*my father and to the memory of my mother,
my grandfather William Dunbar Taylor,
and my great-aunt Lena Taylor*

Preface

What follows represents the culmination of my interests over the last ten years in the areas of development economics, international finance, and the Law. The purpose of this Preface is to outline how my interests in these subjects developed and came together in this work.

The roots of this work lie in my undergraduate studies at McGill University. At the time, I was studying to complete an undergraduate degree in political science and economics and one of my courses, which was given by Professor Thomas Naylor, was on the informal economy. Professor Naylor emphasised that the processes associated with globalisation and market integration have reshaped both the formal and informal economies. The two sectors have not only grown in tandem, but also in symbiosis. The growth of the informal economy since the 1960's, and its exponential growth since the 1980's primarily due to the narcotics trade, has meant that the informal economy has come to form an important part of the economy of most developed countries and of the international economy itself. Contemporary economic theory, let alone the other social sciences, however, has little to say about the subject. In the past, the informal economy has been a peripheral topic of academic analysis. Part of the reason concerns the practical problems associated with investigating the phenomenon, while another part has to do with the lack of recognition of the range of diverse and dynamic economic activity sheltered by the sector. Given that today three of the world's largest businesses are the trade in narcotics, the illegal trade in military equipment (including the trade in the technologies of mass destruction), and the human slave trade, the growth and development of the informal economy is not something to be overlooked.

As a graduate student at the University of Cambridge, I focused my undergraduate studies in the area of development economics. Here, I had the opportunity to study under Dr. Mustafa Khan and Dr. Ha-joon Chang who emphasised the idea that the International Monetary Fund and the World Bank have required most developing countries to pursue a development paradigm based on the experience of the West that does not necessarily have relevance for many developing countries. In particular, Liberal-Market Capitalism in conjunction with multiparty democracy has been promoted as the primary development strategy almost to the exclusion of alternative paradigms such as those being pursued in Asia, which, despite certain setbacks, remain robust, as well as those advocated by academics like Amartya Sen. Until recently, the International Monetary Fund and World Bank have tended to pay relatively little

attention to issues that involve basic human needs like clean water, education, and health care. They have tended to overlook issues that involve women's rights and the need to promote micro-credit programmes. Most importantly, they have tended not to address directly the issues associated with corruption. What is clear is that corrupt bureaucracies and weak legal institutions are two of the most important factors that have contributed to many development opportunities being squandered. Nowhere has this been more prevalent than in countries like Haiti, Zaire, and the Philippines, where the Duvaliers, Mobutu, and the Marcoses tended to view access to foreign aid and development assistance simply as a means to enrich themselves through the embezzlement of such funds. Admittedly, these are extreme cases. However, the tragedy associated with the embezzlement of this money is striking when viewed in the context of the lost opportunities associated with the projects that could have been financed to promote those development issues noted above. US\$1 billion (let alone, it is rumoured, US\$30 billion in the case of "Saviour Guide" Mobutu) would help to ensure an ample supply of clean water and basic healthcare.

As a law student at the University of Cambridge, through a seminar course in law and economics given by David Howarth and Diane Dawson, I was able to bring together my interests in the informal economy with my interests in the Law. As part of the seminar course, we were required to complete a dissertation on a topic of our choice, my choice being money laundering. This topic has come to be a focus issue in many countries. I was particularly interested in the function money laundering performs in linking the formal and informal economies and how the Law was being used to disrupt this function. Without money laundering services, after all, resources spent on development projects would not be squandered on graft and corruption, political leaders would not be able to embezzle money from the state, while the informal economy itself would be starved of resources and dramatically shrink. At the same time, the research associated with my dissertation brought back into focus for me the lack of academic analysis that exists on informal economic activity like money laundering. Through researching my dissertation, I found that the legal literature tends to merely review the legislation that exists to control money laundering, while the economic literature tends to analyse the topic in only an oblique manner, usually through studies on capital flight.

When I began the research for this book, my original intention was to bring together my interests in the informal economy, development economics, and the Law by adopting an institutional perspective and focusing on the problems posed to developing countries by money laundering and weak legal institutions. In particular, I intended to focus on the problems posed by grand corruption and the embezzlement of state funds, and the challenges associated with recovering such monies. The idea was to build on the work begun in my dissertation and to look at how the laws being passed to control money laundering could be used in this context. What has emerged, however, is an enquiry that is much broader in its scope. The focus has shifted to be on money laundering as a subject of inquiry in its own right, while my approach instead adopts a multidisciplinary perspective. This approach follows from another theme identified in the lectures I attended given by Professor Naylor that to understand informal economic activity requires a cross-disciplinary methodology akin to political economy. What has proved to be a considerable challenge has been to develop an adequate analysis of the

Preface

many issues to which such an approach gives rise. My hope, however, is that by adopting this approach, part of the analytical gap I have found to exist in respect of informal economic activity may be filled, and that the analysis itself may be richer than an analysis based solely on the relevant Law or money laundering's financial aspects.

The original structure of this book was divided into three parts in addition to the first and last chapters. The events of September 11, 2001, however, came at a time when this book was in production and the prominent role terrorism will now play in money laundering control strategies has brought about a slight restructuring. As such, Chapters 1 to 11 follow the original structure. Chapter 1 provides an introduction by defining money laundering and placing the issues and challenges associated with the phenomenon into a contemporary context. Part I then attempts to place money laundering into a theoretical framework. Chapter 2 examines the politics of money laundering and looks at why governments may at times unintentionally support, deliberately overlook, or even engage in money laundering. Chapter 3 develops three economic models that demonstrate why money laundering is a rational activity in which to engage, and some of the policy implications associated with attempting to curtail the trade in financial secrecy services. Chapter 4 looks at the legal principles that ought to be considered and taken into account when laws to control money laundering are drafted and put into place. Part II investigates the existing legal initiatives that aim to control money laundering. Chapter 5 examines the initiatives being pursued by the European Union, while Chapter 6 examines the initiatives being pursued by the United States, which together are the most important initiatives that will dictate how other jurisdictions approach the topic. Meanwhile, Chapter 7 examines a series of soft law related initiatives that are being pursued by the Financial Action Task Force, Organisation for Economic Co-operation and Development, the Financial Stability Forum, and certain private banks. Part III explores the practical challenges associated with preventing, identifying, and investigating money laundering and prosecuting money launderers. Chapter 8 examines the issues that confront financial institutions who bear the primary burden of implementing the money laundering control measures required by the Law. Chapter 9 considers the challenges that government regulators must address in their attempts to prevent the financial markets from being infiltrated by criminal elements. Chapter 10 analyses the problems law enforcement agencies confront as they attempt to investigate and prosecute the activities of money launderers. Chapter 11 provides a summary. To take into account the events of September 11, 2001, an additional chapter, Chapter 12, has now been inserted, which focuses on terrorism and money laundering.

I would like to thank the various people who have been involved, in at least one way or another, in the preparation of this book. First and foremost, I would like to thank Dr. Barry Rider for providing me with the opportunity to study under him, and for providing me with the guidance, help, and insight that made this book possible. In addition, I owe a great debt of gratitude to John Hopkins of Downing College who took a chance on me in agreeing to supervise my Law studies at Cambridge. Certainly without his help, I would not have accomplished what I have to date, and to him and his wife, Cherry Hopkins, I would like to say a very special thank you. I would also like to thank the Pennsylvania Securities Commission, in particular Philip Rutledge, G.E. Capital, in particular Colin

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Introduction

*"I noticed a subtle return to traditional norms.
The other day I saw a company with the name 296339 and Sons."*
E. L. Janssens

INTRODUCTION

Money laundering is criminal finance. It corrupts markets, shifts an unfair economic burden onto participants in the legal economy, undermines the systemic stability of the international financial markets, and raises various civil liberty related issues. The last 15 and especially the last five years have seen a lot of activity that aims to control money laundering. This book focuses on the problems posed by money laundering to the economic, political, and social structures of society, and on the theoretical and practical dimensions of the challenges associated with attempting to control the phenomenon. By way of introduction, the comments of former United States Treasury Secretary Lawrence Summers and former Attorney General Janet Reno in the foreword to *The National Money Laundering Strategy for 1999*, the United States' first national report on money laundering published jointly by the Department of the Treasury and the Department of Justice, are of note:

"Money laundering is the financial side of virtually all crime for profit. ... This gives money laundering a dual importance. First, it provides the fuel that allows criminals and criminal organisations to conduct their ongoing affairs. It may seem like an antiseptic form of crime ... But make no mistake, it is the companion of brutality, deceit and corruption. As the President said in his October 1995 speech before the U.N. General Assembly, 'We must not allow [criminal enterprises] to wash the blood off profits from the sale of drugs, from terror or organised crime.' Second, money laundering is important in its own right. It taints our financial institutions, and, where allowed to thrive, it erodes public trust in their integrity. Further, in an age of rapidly advancing technology and globalisation, it can affect trade flows and ultimately disturb financial stability. In the end, like the crime and corruption of which it is a necessary part, money laundering is an issue of national security¹."

¹ United States Department of the Treasury and United States Department of Justice, *The National Money Laundering Strategy for 1999* @ www.treas.gov, 3.

Money laundering no longer remains a marginal economic activity. Globalisation, integration within the financial markets, and technological innovation, fundamental forces at work within the global economy today as discussed below, have provided participants in both the legal and illegal economies with new opportunities. Today, an efficient money laundering system forms the basis of criminal profitability, as money laundering provides the means through which criminal syndicates are able to extend their influence throughout the legal economy without fear of legal sanction. As noted in a report prepared for the European Commission, "The turbulent growth of illicit markets is forcing us ... to look at the Mafia as a structural component of contemporary geopolitics ... ²." In terms of how to control the growth of illegal markets, organised crime, and money laundering, governments, and in particular their regulatory and law enforcement agencies, have had to confront a new set of challenges. To introduce these challenges, the events that surrounded the collapse of the hedge fund Long-Term Capital Management ("LTCM") are particularly noteworthy³.

In September 1998, LTCM collapsed. Although it managed money for only 100 investors, employed merely 200 people, had only US\$4.67 billion in capital, and did not even exist five years before it failed, LTCM and its sudden demise over a one month period threatened the stability of the global financial system. At the time of its collapse, LTCM had its balance sheet leveraged 28 times and also had notional derivative positions outstanding of US\$1.5 trillion⁴. The sheer size of these positions meant that unwinding them would be difficult, while the number of counter-parties tied to the hedge fund through these positions meant that unless their unwind was properly managed, liquidity within the global financial markets would evaporate, and systemic gridlock would ensue. To prevent a financial catastrophe, the major Wall Street banks, under the auspices of the Federal Reserve Bank of New York, hastily agreed to a private bailout and stabilised LTCM with an injection of US\$3.65 billion of fresh capital. The President's Working Group on Financial Markets (the "Working Group"), which investigated LTCM's collapse, concluded that the primary reason for the hedge fund's demise was its excessive leverage. Although money laundering and the unlawful activities it facilitates were not directly responsible for LTCM's failure, money laundering significantly contributed to the LTCM debacle as it has contributed to so

² European Commission Forward Studies Unit, "Organised Criminality Security in Europe" in *Working Papers* (1999) @ www.europa.eu.int, 7.

³ For general discussion on LTCM, see President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (April, 1999) @ www.cftc.gov. See also Alan Greenspan, *Private Sector Refinancing of the Large Hedge Fund, Long-Term Capital Management, Testimony of Alan Greenspan Before the Committee on Banking and Financial Services of the US House of Representatives* (October 1, 1998) @ www.federalreserve.gov. Patrick Parkinson, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, Testimony Before the Committee on Banking and Financial Services of the United States House of Representatives* (May 6, 1999) @ www.federalreserve.gov. See also Nicholas Dunbar, *Inventing Money: The Story of Long-Term Capital Management and the Legends Behind It* (Chichester, England: John Wiley & Sons, Ltd., 2000). Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (London, England: Fourth Estate, 2001). See also Ibrahim Warde, "LTCM, a Hedge Fund Above Suspicion" in *Le Monde Diplomatique* (November, 1998). See also No Author, "LTCM Founder Meriwether Has New Fund – Sources" in *Yahoo Finance* (December 15, 2001) @ www.yahoo.com. Joseph Kahn and Peter Truell, "Hedge Fund's Bets Top US\$1.2 Trillion" in *New York Times* (September 26, 1998). David Henry, "Damaged Goods" in *Business Week* (June 11, 2001). See also Burton Malkiel and J.P. Mei, *Hedge Funds: The New Barbarians at the Gate* (September 29, 1998) @ www.pw1.netcom.com.

⁴ President's Working Group on Financial Markets, 30.

many financial crises in the past. Consequently, LTCM's demise highlights the subtle nuances of the problems posed by money laundering.

It is important to emphasise that LTCM conducted its business in a manner that was both legal and legitimate. In fact, the hedge fund was the envy of Wall Street, returning in excess of 40% on its invested capital in each of the first four years of its operation, and slightly less than 20% in the year preceding its collapse. Legendary bond trader John Meriwether created the hedge fund in 1993 and among his partners were the Nobel Laureates Myron Scholes and Robert Merton whose work on derivatives has revolutionised contemporary finance. Its cadre of seasoned traders, meanwhile, constructed models to identify various arbitrage opportunities within the financial markets, and then exploited these opportunities using trading strategies that involved derivatives and leverage. Overall, LTCM's reputation was of operating aggressively within the financial markets using techniques that pushed the cutting edge of financial theory.

Of the arbitrage opportunities identified by LTCM, one of the most lucrative concerned Russia⁵. In the aftermath of the Soviet Union's collapse, the new Russian government sought to transform the Communist state into a Capitalist society. To finance this transformation, the government issued debt and borrowed money. In world debt markets, Russian bonds carried a premium because of the underdeveloped nature of the Russian economy and the uncertainty associated with whether Russia would be able to make the transition to a market based system. Traders in Russian debt bet that if the money raised by the Russian government through bond issues was successfully used to bring about economic change, then these bonds would be a good investment, as the taxes collected by the Russian government on the country's expanding economic base would be used in part to payoff this debt. In turn, this would cause Russian bond prices to rise allowing those who had purchased the bonds at a relatively depreciated value to earn a potentially substantial profit. The risk of course was that Russia's Capitalist transformation would not go as planned and that the country might be forced to default on part or all of its debt. However, Russia, like most countries with a low credit rating, had issued bonds denominated in both its local currency and American dollars. The debt crisis of the 1980s, facets of which are discussed in Chapter 2, had shown that when they defaulted, such countries tended to default on their dollar denominated bonds, but attempted to continue to make payments on their local currency denominated bonds. To continue to make these payments, however, the government in question would invariably have to increase the money supply. In turn, this would cause inflation and lead to a sharp devaluation in the local currency making the payments received on the country's debt relatively less valuable.

LTCM thought that it had identified a way to make a profit from this situation through the use of a derivative contract known as a non-deliverable forward. LTCM would first enter into a swap agreement with a bank that had purchased rouble denominated bonds. As coupon payments came due, the bank would pay to LTCM the rouble denominated coupon payments in exchange for which LTCM would pay to the bank a dollar denominated sum based on a floating rate of exchange the calculation of which was specified in the swap agreement. Simultaneously upon entering into the swap agreement, LTCM would enter into a forward contract with another bank so that in the future when it received rouble coupon payments, LTCM could immediately exchange the roubles for dollars at the exchange rate that prevailed at the time the forward contract was agreed. In this way, if the rouble devalued between the time the

⁵ For a description of LTCM's trading strategy with respect to Russia, see Dunbar, 198-203.

swap agreement was entered into and future coupon payments were received, LTCM would be protected. To simplify matters, both the swap and derivative contract were expressed in dollars in order to avoid the hassles of actually having to handle and deal with roubles; as such the derivative contract is called a non-deliverable forward. LTCM's counter-parties to both these agreements were usually Russian banks. The incentive for the first Russian bank to enter into the swap agreement was that it would receive dollars in exchange for roubles, while, the incentive for the second Russian bank was that it would earn a fee on writing the derivative contract. Both banks would then hedge any risks to which they were exposed by trading in the domestic currency markets⁶.

The trading strategy that LTCM had built around this arbitrage opportunity, variations of which were also being pursued by other financial institutions active in Russia, could have been profitable, but for at least two important problems that hindered Russia's economic transformation: capital flight and money laundering. Capital flight, which is discussed in Chapter 2, is a form of hot money, a term that is defined below. Much of the money raised by Russia to finance its Capitalist transformation was embezzled, laundered and hidden offshore. In 1999, the United States House of Representatives Committee on Banking and Financial Services in hearings on Russia and money laundering, drew attention to anecdotal evidence that highlighted the magnitude of Russia's problems. In 1993, Russia's Finance Minister Boris Feodorov asked Treasury Secretary Lawrence Summers not to approve a US\$1.5 billion loan to be made by the International Monetary Fund ("IMF") to Russia. According to Finance Minister Feodorov, the loan would undermine his ability to discipline the country's finance ministry:

"I discovered that the budget deficit had grown, because once the money was promised, it was consumed immediately, mostly through graft on government importing schemes. I always told Larry Summers, 'You have the money and the wish to spend it, come and spend. Of course, this money will ultimately be deposited somewhere in Zurich'".⁷

PricewaterhouseCoopers later demonstrated that in 1996, the Russian central bank had funnelled US\$1.2 billion of a subsequent IMF loan to a Jersey based entity called Financial Management Co. As the Russian central bank explained, it had sought to safeguard this money from creditors in the event that serious domestic economic problems arose⁸. Raymond Baker of the Washington D.C. based Brookings Institute estimates that over the last 10 years, US\$200 billion to US\$500 billion has disappeared from Russia⁹. While part of this money was undoubtedly earned through legal activity

⁶ Dunbar, 198-203.

⁷ United States House of Representatives, Committee on Banking and Financial Services, *Russia and Money Laundering* (September 21, 1999) @ www.commdocs.house.gov, 31. Finance Minister Feodorov made this statement in an interview with Ann Williamson. Senator Royce repeats Finance Minister Feodorov's comments. These hearings were followed-up by a second set of hearings in March of 2000. See United States House of Representatives, Committee on Banking and Financial Services, *Money Laundering* (March 9, 2000) @ www.commdocs.house.gov.

⁸ No Author, "Foreign Loans Diverted in Monster Money Laundering? The Mafia, Oligarchs, and Russia's Torment" in *World Bank Group's Transition Newsletter* (1999) @ www.worldbank.org, 3.

⁹ United States Senate, Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, *Private Banking and Money Laundering: A Case Study of Opportunities and Vulnerabilities* (November 9, 1999) @ frwebgate.access.gpo.gov, 89. See also United States Senate, Permanent Sub-

and moved offshore merely to protect it against the deterioration in its purchasing power under Russia's turbulent economic conditions, a sizeable sum was derived from criminal activity. At the same time, recent years have seen substantial growth in Russian organised crime. In 1992, for example, Interpol estimated that the turnover of the Russian drug trade already exceeded 60 billion roubles¹⁰, while today Russian criminal syndicates are one of the structural components of contemporary geopolitics to which the report prepared for the European Commission noted above refers. Russian, money laundering is intrinsically entwined with Russian criminal activity and capital flight. Money laundering serves not only to conceal the proceeds of money derived from criminal activity, such as that embezzled from foreign development assistance, but also plays an important role in avoiding obstacles that hinder the free flow of both dirty and clean money into and out of the country.

Russia's capital flight and organised crime problems gave rise to several scandals that should have served as portents of the underlying instability and problems within Russia's economy. That which engulfed The Bank of New York was among the most prominent¹¹. The Bank of New York is one of America's oldest and largest banks with

committee on Investigations of the Committee on Governmental Affairs, *Minority Staff Report on Private Banking and Money Laundering: A Case Study of Opportunities and Vulnerabilities* (November 9, 1999) @ frwebgate.access.gpo.gov.

¹⁰ United Kingdom House of Commons, Home Affairs Committee on Organised Crime, *Organised Crime: Minutes of Evidence and Memoranda* (London, England: HMSO, 1996), 151.

¹¹ For further reading on capital flight from Russia and The Bank of New York scandal, see United States House of Representatives, Committee on Banking and Financial Services, *Russia and Money Laundering* (September 21, 1999) @ www.commdocs.house.gov, 31. These hearing were followed-up by a second set of hearings in March of 2000. See United States House of Representatives, Committee on Banking and Financial Services, *Money Laundering* (March 9, 2000) @ www.commdocs.house.gov. See also No Author, "Foreign Loans Diverted in Monster Money Laundering? The Mafia, Oligarchs, and Russia's Torment" in *World Bank Group's Transition Newsletter* (1999) @ www.worldbank.org. Andrew Jack, "Moscow Probe Loopholes" in *Financial Times* (February 11, 2001). Giles Whittell, "Russian Leader Faces £3 billion Questions" in *London Times* (July 25, 2000). No Author, "Swiss Convict Lazarenko of Money Laundering" in *Reuters* (June 30, 2000). Timothy O'Brien and Raymond Bonner, "Banker and Husband Tell of Money Laundering Case" in *New York Times* (February 17, 2000). Lucy Komisar, "Russian Cons and New York Banks" in *Village Voice* (December 1, 1999). Timothy O'Brien, "Bank of New York Ex-Employee Charged in Russia Case" in *New York Times* (December 1, 1999). BBC Monitoring Service, "Laundering of Russian Funds through Swiss Banks 'far larger' than Thought" in *Ft.com* (November 14, 2000). Timothy O'Brien and Lowell Bergman, "The Money Movers: Tracking How Pair Went From Russia to Riches" in *New York Times* (October 19, 1999). No Author, "Business: The Economy Following the Rouble: Russia's Trail of Crime" in *BBC Online Network* (October 19, 1999). No Author, "Soyuz' Smolensky: 'To Call it Money Laundering is Ridiculous'" in *Businessweek Online* (September 15, 1999). No Author, "IMF Again Probes Russian Bank for Abuse of Loans" in *New York Daily News Online* (September 7, 1999). John Tagliabue, "Swiss Investigate Possible Laundering of Russian Money" in *New York Times* (September 4, 1999). Raymond Bonner, "Bank of New York Dismisses Second Employee in Laundering Case" in *New York Times* (September 3, 1999). Richard Stevenson, "In Wake of Corruption Case, US Focuses on Aid to Russia" in *New York Times* (September 2, 1999). Timothy O'Brien, "US\$6.75 Million Mansion Awaits Jailed Ukraine Owner" in *New York Times* (September 1, 1999). Robert O'Harrow, "Dozens of Banks Implicated in Laundering Scandal" in *Seattle Times* (September 1, 1999). Corey Goldman, "Watching Overseas Funds" in *CNNfn* (September 1, 1999). Michael Gordon, "Suspect in Russian Money Laundering is Denying Any Crime" in *New York Times* (August 29, 1999). Timothy O'Brien and Raymond Bonner, "Bank Called Long Unaware of Big, Suspicious Transfers" in *New York Times* (August 27, 1999). Michael Gordon, "Businessman at Center of Investigation Becomes a Celebrity in Russia" in *New York Times* (August 28, 1999). Raymond Bonner, "Bank of New York Dismisses One Target of Money Laundering Investigation" in *New York Times* (August 28, 1999). Timothy O'Brien, "Russian Industrialist in Money Laundering Inquiry Accuses Moscow Aides" in *New York Times* (August 28, 1999). Timothy O'Brien and Raymond Bonner, "Reno and British Set Up Money Laundering Inquiry at Bank of New York" in *New York Times* (August 25,