

**THE ROLE OF INTERNATIONAL FINANCIAL INSTITUTIONS IN  
PROMOTING STABILITY IN THE FACE OF FINANCIAL MISCONDUCT AND  
THE POSSIBLE CONTRIBUTION THAT ISLAMIC FINANCE CAN MAKE TO  
STABILITY**

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## DECLARATION

I declare that this thesis represents my own work, except where due acknowledgment is made and that it has not been previously included in a thesis, dissertation or report submitted to this University or to any other institution for a degree, diploma or other qualification.

Signed by: Mohammad Naffa

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## ABSTRACT

Financial crimes pose a serious threat to the stability and security of the financial system. Financial crimes are tackled via many channels, but a significant role is played by International Financial Institutions (IFIs), which are essentially dependent on the advancement of compliance and integrity-based culture that understands the threats, risks, and actions needed to decrease criminal interference with legitimate businesses and institutions. This thesis examines IFI's principles, standards and mandates designed to reduce the risk of financial crimes in the international financial system.

The prevention regime used by IFIs ranges from employing soft law to a legal framework that requires global cooperative measures and implementation of minimum levels of transparency. IFIs also work to compel disclosure to prevent financial crimes, promote stability and more importantly to create a culture of integrity rather than a culture of compliance. In order to do so, this thesis carries out an analysis of current policies and frameworks adapted by IFIs based on relevant and practical experience. It also evaluates governance structure and decision-making processes with a main focus on compliance issues and how far these are implemented in practice.

This thesis also examines whether there is a real threat to the stability of the banking system, and failures of compliance and enforcement measures through a comparative analysis between the American and the British law dealing with financial market regulation and financial crime, through finding lacuna within both systems and evaluating the most rational solutions to promote stability and implement practical compliance.

As an example of stability and prosperity in the financial system, this thesis examines the Islamic banking system and whether it is more resilient to financial crime. In conclusion, this thesis analyses the different legal mechanisms and compliance tools within financial institutions through sanctions and cross department regimes, and how far IFIs have the chance to concretely protect the global financial stability. At the end, an assessment and recommendations will be provided.

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## TABLE OF ABBREVIATIONS AND ACRONYMS

AAOIFI	The Accounting and Auditing Organization for Islamic Financial Institutions
DJIM	Dow Jones Islamic Market Index
DTA 1994	Drug Trafficking Act 1994
EC	European Communities
EU	European Union
FATF	Financial Action Task Force on Money Laundering
FCA	Financial Conduct Authority
FSA	Financial Services Authority
FSA 1986	Financial Services Act 1986
FSMA 2000	Financial Services and Markets Act 2000
FTSE	Financial Times Stock Exchange
GCC	Gulf Cooperation Council
IAHs	Investment Account Holders
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IFIs	International Financial Institutions
IFRSs	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRR	Investment Risk Reserve
KYC	Know Your Customer



MIBOC	Marketing of Investments Board Organizing Committee
OAS	Organization of American States
OECD	Organization for Economic Co-operation and Development
OIC	Organization of the Islamic Conference
OTC	Over-the-counter
UK	United Kingdom
UN	United Nations
US	United States
PER	Profit Equalization Reserve
POCA	Proceeds of Crime Act 2002
SAC	Shariah Advisory Council
SIB	Securities Investment Board
SEC	Securities and Exchange Commission
SPV	Special Purpose Vehicle
SSB	Shari'ah Supervisory Board

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- US Securities Exchange Act of 1934
- US Treasury Department Executive Order 13224

## CHAPTER 1

### Introduction

This research aims to suggest improvements to currently applied role of International Financial Institution (IFIs), mainly the World Bank and the International Monetary Fund (IMF). As leading international institute, the IMF promotes stability in the face of the financial misconduct. This analysis will include examining the effectiveness of their role and suggesting solutions to improve their role in promoting stability and fighting financial misconduct. To do this, a comparative analysis research methodology will be followed based on U.S and UK's laws as leading financial regulators. The research is based on a literature review of IFIs role in promoting stability and financial crimes regulations in U.S and UK as well as a number of scholarly works written about the role of IFIs in promoting stability and its functions through surveillance and technical assistance.

A country's financial system is composed of various parts and players including banks, securities markets, pension and mutual funds, insurers, market infrastructures, central bank, as well as regulatory and supervisory authorities. Although it is easy to identify the components of a financial system, it is not as easy to determine whether the financial system is stable or unstable.<sup>1</sup> One manner of identifying a stable financial system is the lack of excessive unpredictability, stress, or crises.<sup>2</sup> However, this definition fails to identify the effect on overall economic performance when a financial system is working efficiently. As such, a more encompassing definition would be "a condition in which the financial system comprising financial intermediaries, markets and market infrastructure is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are

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<sup>1</sup> Blaise Gadanecz and Kaushik Jayaram, Measures of Financial Stability – A Review, IFC Bulletin No. 31, 265 (2008), available at <http://www.bis.org/ifc/publ/ifcb31ab.pdf> (noting it is difficult to define and measure financial stability); see also Sanderson Abel, Importance of Financial Stability, The Herald, <http://www.herald.co.zw/importance-of-financial-stability/> (Oct. 14, 2015) (defining financial stability when financial intermediaries, markets and market infrastructure facilitate the smooth flow of funds between savers and investors and, by doing so, help promote growth in economic activity).

<sup>2</sup> Ibid.

severe enough to significantly impair the allocation of savings to profitable investment opportunities.”<sup>3</sup> Thus, a financial system is stable when it enhances economic performance and wealth accumulation while at the same time averting negative disturbances.

The stability of the financial system is critical to efficiently allocating resources, assessing and managing financial risks, maintaining employment levels close to the economy’s natural rate, and eliminating relative price movements of real or financial assets that affect monetary stability or employment levels. This efficient flow of funds and resources helps to promote growth in economic activities.<sup>4</sup> The various entities composing the financial system thus have a responsibility in mitigating risks of financial disruptions that may produce consequences and in responding to any such financial disruptions which create the justification for this research.

In recent years, financial stability has become a global priority for a number of factors.<sup>5</sup> This increased focus is due to the expansion and globalization of financial systems, which can have greater consequences on financial instability and economic performance.<sup>6</sup> As it can be noted then, financial stability is a “public good” and governments and international organizations continuously aim to maintain financial stability, given that financial instability may result in adverse effects on the overall economy due to inefficiencies that arise.<sup>7</sup> Systematic financial crisis are potentially hazardous and could cause serious damage to the financial markets thereby undermining the functioning efficiency of the market creating harmful reactions on the economy.<sup>8</sup>

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<sup>3</sup> Progress towards a framework for financial stability assessment, Speech by José-Manuel González-Páramo, Member of the Executive Board of the European Central Bank, OECD World Forum on “Statistics, Knowledge and Policy,” <https://www.ecb.europa.eu/press/key/date/2007/html/sp070628.en.html> (June 28, 2007).

<sup>4</sup> Tatjana Jovanic, Governance Arrangements for Financial Stability – with Particular Focus on CEE, Draft Paper (June 2014), available at <http://reggov2014.ibe.org/bcn-14-papers/31-148.pdf>.

<sup>5</sup> See Aerdts Houben et al., Toward a Framework for Safeguarding Financial Stability, Int’l Monetary Fund WP/01/101, 1 (2004), available at <http://www.imf.org/external/pubs/ft/wp/2004/wp04101.pdf> (commenting that periodic financial stability reports have been conducted by various central banks and several international financial institutions).

<sup>6</sup> Ibid.

<sup>7</sup> A. Crockett, why is Financial Stability a Goal of Public Policy, Federal Reserve Bank of Kansas City Economic Review, Fourth Quarter, 5, 11 (1997).

<sup>8</sup> Ibid.



Much of the agenda for financial regulation is driven by international organizations, which produce ‘soft law’ instruments that are converted into legislative form in the various jurisdictions.<sup>9</sup> One example of this is the Basel documents that the Basel Committee on Banking Supervision has published, which do not have a direct effect. The Basel II Framework has been transposed into the laws in many countries. Basel III Framework is undergoing the same process.<sup>10</sup> Financial regulation is therefore essential in aiding and maintaining financial stability and soundness. Moreover, the soundness of the banking and financial markets depend heavily on the perception that it functions within a framework of high legal, professional and ethical standards in order to create confidence in the economy. As can be imagined, financial crimes<sup>11</sup> can create adverse effects on the financial system, both regionally and globally. For this reason, it is essential that the financial system continuously work to fight financial crimes.

The focus of this thesis will be to examine the ways that financial crimes and corruption affect financial stability and how IFIs should tackle the problems that can be caused by these crimes. In practice, economic crime, organized or otherwise, is synonymous with white-collar crime.<sup>12</sup> The UK’s National Crime Agency (NCA)<sup>13</sup> has identified the key threats relating to economic crime as fraud, bribery, corruption and sanctions evasion, market abuse and insider dealing, money laundering and criminal finance, counterfeit currency and cyber-enabled identity crimes.<sup>14</sup> This thesis will emphasize that the World Bank and the International Monetary Fund are leading International Financial Institutions that provide financial support and professional advice

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<sup>9</sup> See Research Hand Book on International Financial Crime Edited by Barry Rider “Responsibility and accountability in the financial sector” by Graeme Baber /For a synopsis see Graeme Baber ‘International Financial Regulation: Order or Chaos? [2012] 33(1) Comp Law17.

<sup>10</sup> Ibid.

<sup>11</sup> See IMF, Financial System Abuse, Financial Crime and Money Laundering – Background Paper, (Int’l Monetary Fund, 12 Feb. 2001, 3) (noting that there is no universal definition for financial crime but defining it as “any non-violent crime that generally results in a financial loss”).

<sup>12</sup> ‘White collar crime’ is a term coined by sociologist Professor Edwin Sutherland as ‘crime committed by a person respectability and high social status in course of his occupation’ to describe non-violent crime committed for monetary gain.

<sup>13</sup> National Crime Agency, Economic Crime Command’ <http://www.nationalcrimeagency.gov.uk/about-us/what-we-do/economic-crime> accessed June 12, 2016

<sup>14</sup> National Crime Agency, Strategic Assessment of Serious and organized Crime 2014,1 May 2014, p. 21

for economic and social development activities and promote international economic cooperation and stability.

### **The World Bank and the International Monetary Fund**

The term international financial institution typically refers to United Nation's (UN) financial arm which consists of the International Monetary Fund (IMF) and the five multilateral development banks (MDBs): The World Bank Group (WB), the African Development Bank, the Asian Development Bank, the Inter-American Development Bank and the European Bank for reconstruction and development. All but the IMF and WB focus on a single region of the world and hence are called regional development banks. The IMF and World Bank, in contrast, are specialized and global in their scope and governed independently of the UN. Therefore, my focus in this thesis will be on the World Bank and the IMF.<sup>15</sup>

The World Bank is devoted to analysis and advocacy in the global arena, especially with respect to the policies and actions of developed countries on the trade, aid, and debt relieve. Within this purview, importance is given to addressing these global issues and reducing poverty. As the only global institution among the MDBs, the WB has increased its support for global programs rapidly in recent years, with more than 70 different programs addressing many global issues. A major expansion of the WB's work on global issues began in the late 1990s when the Bank increased its orientation toward global partnerships and associated program support activities. This change in policy reflected the Bank's recognition of the rapid pace of globalization and the sharply increased attention to global policy issues within the development community. Many of these programs featured partnerships focused on the delivery of global and regional public goods, including the prevention of seed money.

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<sup>15</sup> The Role of the International Financial Institutions in addressing Global Issue by Vinay Bhargava.

In 2000, the Development Committee endorsed the Bank's priorities in supporting global public goods. These priorities focused on five areas: public health, protection of the globe commons, financial stability, trade, and knowledge.<sup>16</sup> The IMF continues to play a central role in addressing global issues relating to promoting stability and open global economic and financial polices of those countries that, because of their size or critical role in the international trade and finance, are important to the health of the global economic system. The consultations with industrial countries that the IMF conducts under Article IV of its Articles of Agreement are vehicles for promoting appropriate policies, such as curbing domestic imbalances that may pose risks for the global economy. The IMF also has become increasingly active in multilateral surveillance, highlighting both macroeconomic and financial risk as they emerge at the global level. IMF is planning to make its surveillance more effective through more incisive analysis of specific weak nesses and distortions in the global financial system that raise the risk of crisis or contagion or hinder adjustment to globalization. It will also promote international dialogue within the international community on multilateral actions necessary to ensure global financial stability.<sup>17</sup>

Despite the concerted efforts by national and international agencies especially the WB and the IMF, it is still impossible to accurately calculate the true extent of financial crimes that take place on a daily basis around the world. However, it is of the utmost importance to focus attention on regulating these crimes given that "criminal proceeds have the power to corrupt and ultimately destabilize communities or whole national economies."<sup>18</sup> This thesis will argue for the need for greater financial regulation as opposed to deregulation, given that the reliability of financial institutions can erode and the overall national security can be affected when financial system instability ensues due to financial crimes.<sup>19</sup>

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<sup>16</sup> Ibid.

<sup>17</sup> Ibid.

<sup>18</sup> Financial Action Task Force, Report on Money Laundering and Terrorist Financing Typologies 2003-2004 (Financial Action Task Force 2004).

<sup>19</sup> See Financial System Abuse, Financial Crime and Money Laundering – Background Paper, supra note 46, at 12 ("Weak financial institutions, inadequate regulation and supervision, and lack of transparency were at the heart of the financial crises of the late 1990s as well as the recent global financial crisis. The recent crisis also highlighted the importance of effective systemic risk monitoring and management.")

## **Financial crimes impact on economic, social and political stability**

Organized crime is one of the greatest threats to human, national and international security throughout the world.<sup>20</sup> It is not only a threat to the world, but also a daily reality that causes immense harm to individuals, families, and communities,<sup>21</sup> and is capable of undermining governance, fuelling corruption and hindering economic development.<sup>22</sup> Financial crimes have particularly significant economic and social consequences for developing countries, and are more susceptible to disruption. Therefore, financial stability is essential for national and international economic growth.

This thesis will argue that further market reform is needed to enhance the fight against financial crimes that continue to be on the rise. In recent years, financial market reform has mainly focused on the threats to financial stability that arise from legal activities in the financial industry characterized by excessive risk taking, distortive incentives, and the lack of controls in the overall regulatory financial work.<sup>23</sup> Although these issues do indeed need to be addressed, the threat to the economic and financial security caused by illegal financial activities cannot be ignored and more focus should be placed on them. These crimes often can occur more easily due to the lack of regulation and weak supervision of the activities of the financial sector especially in development countries with fragile financial systems because they are too susceptible from such influence.<sup>24</sup> The economy, society, and ultimately the security of countries used as money laundering platforms are all imperilled.<sup>25</sup> The possible social and political costs of financial crimes, if left unchecked or dealt with ineffectively, are serious. Financial crime can infiltrate

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<sup>20</sup> Research Handbook/ International Financial Crimes/ Edited by Professor Barry Rider (Organized economic crime by Shima D. Keene P. 65 Published by Edwards Elgar 2015.

<sup>21</sup> National Crime Agency, National Strategic Assessment of Serious and organized Crime 201, May 2014, p.1.

<sup>22</sup> World Economic forum, Global Agenda Counsel on Organized Crime 2012-2013' <http://www.weforum.org/content/gobal-agenda-council-organized-crim-201-2013>>accessed 2 June 2014

<sup>23</sup> FINANCIAL CRIMES: A THREAT TO GLOBAL SECURITY xvii (ed. Maximilian Edelbacher et al., 2012)

<sup>24</sup> Reference Guide to Anti –Money Laundering and combating the Financial of Terrorism /World Bank II-1 [http://siteresources.worldbank.org/EXTAML/Resources/3965111146581427871/Reference\\_Guide\\_AMLCFT\\_2ndSupplement.pdf](http://siteresources.worldbank.org/EXTAML/Resources/3965111146581427871/Reference_Guide_AMLCFT_2ndSupplement.pdf)

<sup>25</sup> For a detailed discussion of negative economic effects of money laundering see Brent L. Bartlett “Negative Effects of Money Laundering on Economic Development” (an Economic Research Report prepared for the Asian Development Bank, June 2002.) See also John McDowell and Gary Novis, “Economic Prospective” United States, State Department (May 2001)

financial institutions, acquire control of large sectors of economy through investment, or offer bribes to public officials and, indeed government.<sup>26</sup> The economic and political influence of criminal organizations can weaken the social fabric, collective ethical standards, and, ultimately, the democratic institutions of society.<sup>27</sup>

This criminal influence can undermine countries, undergoing the transition to democratic systems. In addition, a reputation for integrity, soundness, honesty, and adherence to standards codes is one of the most valued assets by investors, financial institutions, and jurisdictions.<sup>28</sup> The important link between financial market integrity and financial stability is understood in the Basel Core Principles for Effective Supervision and the Code of Good Practices on Transparency in Monetary and Financial Polices, particularly those principles and codes that most directly address the prevention uncovering, and reporting of financial system abuse, including financial crime, and money laundering.<sup>29</sup>

Therefore, an effective framework for combating financial crimes has important benefits, both domestically and internationally, for a county. These benefits include lower levels of crime and corruption, enhanced stability of financial institutions and markets, positive impact on economic development and reputation in the world community, enhanced risk management techniques for the country's financial institutions, and increased market integrity.<sup>30</sup> Advanced information technologies and networks now offer a surplus of benefits and opportunities, but also have developed many challenges.<sup>31</sup>

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<sup>26</sup> Financial Action Task Force Report ([www.fatf-gafi.org/faq/moneylaundering](http://www.fatf-gafi.org/faq/moneylaundering)).

<sup>27</sup> Ibid.

<sup>28</sup> IMF "Financial System Abuse" Financial Crime and Money Laundering Background Paper February 12, 2001"

<sup>29</sup> These would include the Basel Coe Principles 14,15,18,19 and 21. The guidelines on central bank internal governance and audit on the conduct of public officials, and on accountability and assurances of integrity by financial institutions contained in the Code of Good Practices on Transparency in Monetary and Financial Polices. More generally, see Experience with Basel Core Principles Assessments (SM/00/77, April 12, 2000), for a discussion of the motivation and experience with Basel Core Principles Assessment (BCPA).

<sup>30</sup> Ibid.

<sup>31</sup> Nicholas Ryder et al., The Law of Financial Crimes in the Global Economic Crises. p.75 (Edward Edger 2014)

Financial crimes have become one of these challenges. Financial crimes severely weaken the integrity and stability of financial institutions and systems, discourage investment into productive sectors, and distort international capital flows.<sup>32</sup> Transnational crimes cross boundaries and borders and take on different forms such as; money laundering, financing terrorism, fraud, corruption, and cybercrime. International financial institutions have had to shift their roles in order to help the international community step up and combat these challenges.

International Financial Institutions, primarily the World Bank and the International Monetary Fund, play a critical role in protecting the integrity of the global financial system from abuse resulting from financial crimes.<sup>33</sup> A particular focus has challenged money laundering and terrorist funding because it has been argued that these are at the “heart of virtually all criminal activity within and across borders”.<sup>34</sup>

This thesis will discuss the major financial crimes that have emerged and the way the IMF and World Bank have had to tackle new obstacles because of the proliferation of global financial crimes. The thesis will argue that the IMF and World Bank are the agencies to turn to in order to combat financial crimes due to their resources and capabilities, and will also discuss the tools that the IMF and World Bank can utilize in a different way and others that can be expanded on or bettered in order to achieve these aims.

Financial crimes are becoming transnational.<sup>35</sup> The globalization of financial crimes affects millions of people,<sup>36</sup> causes tremendous losses of money,<sup>37</sup> and empowers

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<sup>32</sup> Financial Crime Risk & Policy Group. International Chamber of Commerce, <http://www.iccwbo.org/About-ICC/Policy-Commissions/Banking/Task-forces/Financial-Crime-Risk-Policy>.

<sup>33</sup> Ibid.

<sup>34</sup> Ibid.

<sup>35</sup> Neil Boister, *An Introduction to Transnational Criminal Law* (Oxford University Press 2012)

<sup>36</sup> See Editorial, *Libor's Trillion-Dollar Question*, BLOOMBERG (Aug. 27, 2012), <http://www.bloomberg.com/news/2012-08-27/libor-s-trillion-dollar-question.html> (detailing the Libor rate price fixing fraud and finding that the Libor rate affects virtually all financing agreement from credit cards to auto finance to mortgages).

<sup>37</sup> See Ibid. (“If, for example, underreporting caused Libor to be artificially depressed by 0.1 percentage point for only a few months, payments on more than \$300 trillion in mortgages, corporate bonds and derivatives tied to the benchmark might have fallen short by about \$75 billion or so. If the problem lasted a

rogue leaders to steal national wealth.<sup>38</sup> Recent admissions, settlements and investigations have exposed widespread global racketeering and fraud by large global corporations resembling organized crime more than banking.<sup>39</sup>

Moreover, terrorist acts have continued to grow, demonstrating the various financial tools being used to fund such operations.<sup>40</sup> The stability of the financial system is critical in order to efficiently allocate resources, assess and manage financial risks, maintain employment levels close to the economy's natural rate, and eliminate relative price movements of real or financial assets that will affect monetary stability or employment levels. This efficient flow of funds and resources helps to promote growth in economic activities.<sup>41</sup> The various entities composing the financial system thus have a responsibility to mitigate risks of financial disruptions that may produce consequences and in responding to any such financial disruptions.

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few years, the shortfall could be close to \$1 trillion”), The Current State of Cyber Crime 2013: An Insider Look at the Changing Threat Landscape; (EMC, White Paper 2013), available at <http://www.emc.com/collateral/fraud-report/current-state-cybercrime-2013.pdf> (noting that cybercrimes have cause upwards of \$7.5 billion in losses).

<sup>38</sup> Joe Palazzolo, Tunisia Hires Ace to Track Down Ben Ali's Assets, WALL ST. J. BLOG (Oct. 24, 2011), <http://blogs.wsj.com/law/2011/10/24/tunisia-hires-ace-to-track-down-ben-alis-assets> (commenting that former Tunisian President and his family stole from the nation and retelling the efforts to recover the assets); How Did Egypt Become So Corrupt? Al Jazeera (Feb. 8, 2011), <http://www.aljazeera.com/programmes/insidestory/2011/02/201128111236245847.html> (remarking on the extensive corruption in Egypt); Lanny A. Breuer, Assistant Attorney General, U.S. Dep't of Justice, Speech at the Twenty Sixth National Conference on the Foreign Corrupt Practices Act (Nov. 8, 2011), available at <http://www.justice.gov/criminal/pr/speeches/2011/crm-speech-111108.html> (discussing the origins of the “Arab Spring” to a young Tunisian who was the victim of local corruption).

<sup>39</sup> Ellen Rosen, Municipal Bonds, UPS, JPMorgan, Student Loans: Compliance, BLOOMBERG (July 23, 2012), <http://www.bloomberg.com/news/2012-07-23/municipal-bonds-ups-jpmorgan-student-loans-compliance.html> (explaining illicit activity at thirteen major banks, including Bank of America, JPMorgan Chase & Co. and UBS AG); Jessica Silver-Greenberg, Regulator Says British Bank Helped Iran Hide Deals, N.Y. TIMES, Aug. 7, 2012, available at <http://www.nytimes.com/2012/08/07/business/standard-chartered-bank-accused-of-hiding-transactions-with-iranians.html?r=1&hp> (“In June, the Justice Department and the New York County district attorney's office reached a \$619 million settlement with ING Bank over accusations that it had illegally moved billions of dollars into the United States for sanctioned Cuban and Iranian entities.”).

<sup>40</sup> Shima Baradaran et. al., Funding Terror, 162 U. PA. L. REV. 477, 488 (2014) (conveying the financial tools terrorist organizations are known to use to fund their activities).

<sup>41</sup> Tatjana Jovanic, Governance Arrangements for Financial Stability – with Particular Focus on CEE, Draft Paper (June 2014), available at <http://reggov2014.ibeio.org/bcn-14-papers/31-148.pdf>.

In recent years, financial stability has become a global priority due to a number of factors.<sup>42</sup> This focus has come about due to the expansion and globalization of financial systems, which can have greater consequences than financial instability on economic performance.<sup>43</sup> As it can be noted then, financial stability is a “public good” and governments and international organizations continuously aim to maintain financial stability, given that financial instability may result in adverse effects on the overall economy due to inefficiencies that arise.<sup>44</sup>

Systematic financial crisis are potentially hazardous and could cause serious damage to the financial markets thereby undermining the functioning efficiency of the market creating harmful reactions on the economy.<sup>45</sup> Financial regulation is therefore essential in aiding and maintaining financial stability and soundness. Moreover, the soundness of the banking and financial markets depend heavily on the perception that it functions within a framework of high legal, professional and ethical standards in order to create confidence in the economy. As can be imagined, financial crimes<sup>46</sup> can create adverse effects on the financial system, both regionally and globally. For this reason, it is essential that the financial system continuously work to fight financial crimes

This thesis divides itself into nine (9) chapters. This Chapter consists of an introduction, research methodology, review of the literature and accordingly establishes the justification for this research.

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<sup>42</sup> Aerdts Houben et al., *Toward a Framework for Safeguarding Financial Stability*, Int’l Monetary Fund WP/01/101, 1 (2004), available at <http://www.imf.org/external/pubs/ft/wp/2004/wp04101.pdf> (commenting that periodic financial stability reports have been conducted by various central banks and several international financial institutions).

<sup>43</sup> *Ibid.*

<sup>44</sup> A. Crockett, *Why is Financial Stability a Goal of Public Policy*, Federal Reserve Bank of Kansas City Economic Review, Fourth Quarter, 5, 11 (1997).

<sup>45</sup> *Ibid.*

<sup>46</sup> See International Monetary Fund, *Financial System Abuse, Financial Crime and Money Laundering – Background Paper*, (Int’l Monetary Fund, 12 Feb. 2001, 3) (noting that there is no universal definition for financial crime but defining it as “any non-violent crime that generally results in a financial loss”).



Chapter 2 elucidates insider dealing and how the World Bank and IMF have tackled them in order to promote stability. Recently, there has been a great deal of coverage on financial scandals from all over the world, especially highlighting the crime of insider trading, as it is known in the United States or insider dealing as it is known in other countries.<sup>47</sup> While there is no single definition of insider dealing, it generally refers to the buying or selling of a publicly traded company's stock based on material, non-public information about a particular company.<sup>48</sup> Although some may consider that insider dealing has no real harm or victims, the vast majority find that the market is the main victim of the offences.<sup>49</sup> More so, many find regulation of the market when it comes to insider dealing is counterintuitive given that it hinders competition. However, several problems arise when insiders are left to their own.

When insider dealing surfaces, as it has in recent years, market confidence plummets, raising capital is made more problematic, market efficiency is significantly impacted, and market investors at home and internationally find unfairness and the reputation of the market can diminish. Fraud and insider dealing is often the result of poor asset quality. When there is a lack of proper incentive to act prudently or supervise correctly, then moral hazards can worsen. This can lead to people who may then be guided by objectives that are not compatible with sound financial practices and be shielded from external discipline. Flaws in the legal framework complicate the problems of lax management and weak corporate governance. Once credit quality has been compromised,

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<sup>47</sup> Jeremy Hodges, Biggest Insider-Trading Case in U.K. Started With 'Stag Party', BLOOMBERG, Feb. 29, 2016 (commenting on the U.K.'s largest insider trading trial); Sam Gustin, 'Guilty' Verdict in Biggest U.S. Insider Trading Case, TIME, Feb. 6, 2014 (describing that Mathew Martoma, the former hedge fund trader charged with what federal prosecutors called the most lucrative insider trading scheme in U.S. history); Jane Croft & Brooke Masters, Ex-Cazenove Partner Guilty on Five Counts of Insider Dealing, Fin. Times, Mar. 11, 2010, at 16 (reporting on an insider trading conviction in London); Tom Mitchell, Du Trial is Evidence of How Watchdog is Showing More Bite, Fin. Times, Sept. 11, 2009, at 14 (detailing insider dealing prosecution in Hong Kong); Andrew England & Abeer Allam, First Insider Trader is Jailed in Saudi, FIN. TIMES, Aug. 18, 2009, at 19 (describing the first insider trading criminal prosecution in Saudi Arabia).

<sup>48</sup> Robert E. Wagner, Gordon Gekko to the Rescue? Insider Trading as A Tool to Combat Accounting Fraud, 79 U. CIN. L. REV. 973, 974 (2011).

<sup>49</sup> Tomasic Canberra, Casino Capitalism? Insider Trading in Australia (1991) (quoting those who feel no harm is done from insider dealing considering that "there is a willing seller who would have sold anyway. It is caveat emptor in the marketplace". Another was that it is "a swings and roundabouts situation. There is some damage in blatant cases such as in pre-takeovers").

regulatory shortcomings and supervisory forbearance can aggravate matters by failing to identify problems and preventing them from being addressed in a comprehensive and timely fashion. All of these matters lead to instability when the responsibility begins to fall solely on regulators and supervisors who may not have the capacity to handle the fraud and insider dealing happenings.

Chapter 3 examines the financial institutions' role in fighting money laundering and terrorist funding as a major threat to the financial stability. Money laundering is "the process by which one conceals the existence, illegal source, or illegal application of income, and then disguises that income to make it appear legitimate."<sup>50</sup> Although it is hard to come up with a concrete number, it is estimated that that between \$590 billion and \$1.5 trillion is laundered globally every year, making up 2-5% of the world's GDP.<sup>51</sup> In "cleaning" the funds, money launders are able to make their proceeds appear to be legitimate and have it flow through society without raising suspicion, having it be confiscated and continue their crimes without fear of prosecution for the act.<sup>52</sup> Given the fact that money laundering can be extremely profitable, it has become essential for organized crime and terrorist alike<sup>53</sup> Early anti-money laundering efforts were predominately focused on averting illegal drug trafficking from benefiting from their

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<sup>50</sup> President's Commission on Organized Crime, Interim Report to the President and Attorney General, *The Cash Connection: Organized Crime, Financial Institutions, and Money Laundering* 7 (1984) [hereinafter Interim Report].

<sup>51</sup> Financial Action Task Force, *Frequently Asked Questions*, available at <http://www.fatf-gafi.org/pages/faq/moneylaundering> [hereinafter FATF FAQ]; see also *The IMF and the Fight Against Money Laundering and the Financing of Terrorism*, IMF (Sept. 30, 2013), available at <http://www.imf.org/external/np/exr/facts/aml.htm>. But see id. (remarking that it is impossible to provide a definitive estimate of the amount laundered given the nature of the act itself).

<sup>52</sup> Scott Sultzer, *Money Laundering: The Scope of the Problem and Attempts to Combat It*, 63 *TENN. L. REV.* 143, 148 (1995).

<sup>53</sup> Ronald K. Noble & Court E. Golumbic, *A New Anti-Crime Framework for the World: Merging the Objective and Subjective Models for Fighting Money Laundering*, 30 *N.Y.U. J. INT'L L. & POL.* 79, 84-85 (1998) (describing the importance of money laundering to organized crime activities); see also Michael D. Hoffer, Note, *A Fistful of Dollars: "Operation Casablanca" and the Impact of Extraterritorial Enforcement of United States Money Laundering Law*, 28 *GA. J. INT'L & COMP. L.* 293, 294 (2000) (observing that criminal enterprises would only be able to operate at a "small fraction of current levels" without the use of effective money laundering).

proceeds.<sup>54</sup> While those initial aims are still important, anti-money laundering efforts now have turned their focus to terrorist financing.<sup>55</sup>

Since 9/11, anti-money laundering measures have been the focus for combating terrorist financing.<sup>56</sup> Terrorist financing is the means by which terrorists utilize the financial system to fund their illegal activities.<sup>57</sup> The process of money laundering is essential to terrorist avoiding detection.<sup>58</sup> However, terrorist financing has often been referred to as reverse money laundering given that that it often dirties clean money, but it can also clean dirty money when it launders from criminal or illicit activity.<sup>59</sup>

Both organized crime and terrorist financing use money laundering in similar ways and for similar objectives.<sup>60</sup> Both groups require substantial amounts of money to go undetected.<sup>61</sup> However, terrorist also need to conceal the use of the funds in order to carry out their activities.<sup>62</sup> Consequently, although the aims may be similar, terrorist financing may not always be carried out in the same manner as traditional money laundering.<sup>63</sup> Dirty money has a tendency to flow to countries with less stringent controls. The international laundering of money and terrorist financing has the capacity to cause substantial costs on

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<sup>54</sup> Guy Stessens, *Money Laundering: A New International Law Enforcement Model* (2000) (examining the U.N. Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, entered into force on Nov. 11, 1990).

<sup>55</sup> Paul Allan Schott, *Reference Guide to Anti-money Laundering and Combating the Financing of Terrorism* (2004) (commenting on the scope of money laundering expanding to terrorist financing).

<sup>56</sup> Shima Baradaran et. al., *Funding Terror*, 162 U. PA. L. REV. 477, 490 (2014).

<sup>57</sup> Navin Beekarry, *The International Anti-Money Laundering and Combating the Financing of Terrorism Regulatory Strategy: A Critical Analysis of Compliance Determinants in International Law*, 31 NW. J. INT'L L. & BUS. 137, 153 (2011).

<sup>58</sup> Shima Baradaran et. al., *Funding Terror*, 162 U. PA. L. REV. 477, 488 (2014).

<sup>59</sup> Paul Fagyal, *The Anti-Money Laundering Provisions of the Patriot Act: Should They Be Allowed to Sunset?* 50 ST. LOUIS U. L.J. 1361, 1363 (2006) (explaining that money laundering for terrorist financing has been viewed as “reverse money laundering” when the money is obtained from a legitimate sources such as charity donations and then laundered for illegal purposes).

<sup>60</sup> See FATF, *Terrorist Financing* 34 (2008) (observing the similar needs of money laundering and financing terrorism to “mask financial resources and activities from the scrutiny of state authorities”).

<sup>61</sup> Michael Martuscello, *The Fat's Nine Special Recommendations: A Too "Soft" Approach to Combating Terrorism?* 14 TOURO INT'L L. REV. 363, 364 (2011).

<sup>62</sup> *Ibid.*, at 370.

<sup>63</sup> *Ibid.*

the world economy in various ways. The harms that can occur include (a) damaging the effective operations of the national economies and by promoting poorer economic policies, especially in some countries; (b) slowly corrupting the financial market and reducing the public's confidence in the international financial system, thus increasing risks and the instability of that system; and, (c) as a consequence of (a) and (b), reducing the rate of growth of the world economy.

Due diligence requirements to “know your customer”, the monitoring of financial records as well as the other regulatory actions implemented by countries have shown to raise awareness of the possibility of terrorist financing.<sup>64</sup> However, it is debatable to what extent these measures are benefiting the combat of money laundering and terrorist financing.<sup>65</sup> It is clear that these crimes have not diminished, and the affects they have on financial stability cannot be ignored given the disruption in confidence and efficiency in the market. In practice, countries’ counterterrorist initiatives developed from anti-money laundering hinders their effectiveness.<sup>66</sup> These efforts are more focused on traditional money laundering, not addressing the nuances involved in terrorist financing. What occurs is that these countries simply apply their anti-money laundering tools and relabelled them to combat terrorist financings. Though there are similarities between money laundering and terrorist financing as discussed above, the differences must be addressed in order for a system to be effective, for the state to truly be able to combat terrorist acts, and for the system to be fair to all those regulated. Additionally, more information is needed to even make anti-money laundering efforts more effective because these crimes continue to occur and on the same or greater scale.

Chapter 4 dissects cyber financial crimes as a serious threat to the financial stability; since most significant financial crime are taking place in the internet and digital sectors have become more sophisticated and thus, so have cybercrimes.<sup>67</sup> Cyber criminals grow as

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<sup>64</sup> Richard Barrett, Preventing the Financing of Terrorism, 44 Case W. Res. J. Int'l L. 719, 721 (2012).

<sup>65</sup> Donohue, *supra* note 476, at 390 (commenting that neither the United States nor United Kingdom has been successful in thwarting terrorist operations).

<sup>66</sup> *Ibid.*

<sup>67</sup> Michael Cohn, Financial Crimes Increasingly Become Cybercrimes, Accounting Today, (Mar. 4, 2013) available at [http://www.accountingtoday.com/debits\\_credits/Financial-Crimes-Increasingly-Become-Cybercrimes-65942-1.html](http://www.accountingtoday.com/debits_credits/Financial-Crimes-Increasingly-Become-Cybercrimes-65942-1.html).

the sophistication increases, advancing their skills and methods. As the trend of cybercrimes continues to grow,<sup>68</sup> financial crimes are increasingly turning into cybercrimes.<sup>69</sup> Both organizations and individuals alike are put at risk for fraud as the convergence between the two crimes increases.<sup>70</sup>

The global nature of cyber financial crimes adds to the growing concern.<sup>71</sup> When the internet was first developed, its purpose was to facilitate the sharing of data, research and statistics between the United States and Europe.<sup>72</sup> Now, the internet controls a large portion of peoples' lives all over the world.<sup>73</sup> The growth of internet usage thus has contributed significantly to the burgeoning of cybercrime and fraudulent activity.<sup>74</sup> In the United States, it has been estimated that the cost of cybercrime is as much as \$100 billion dollars per year,<sup>75</sup> while in the United Kingdom, estimates have been found at £27 billion per year.<sup>76</sup> However, experts have difficulty calculating the exact amount of damages caused by cyber financial crimes due to: (1) the lack of a concise definition of cybercrime;<sup>77</sup> (2) the reluctance of companies to report incidents due to fear of losing consumer

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<sup>68</sup> See 2014 Global Economic Crime Survey 28 (PwC 2014) [hereinafter ECONOMIC CRIME SURVEY] available at <http://www.pwc.com/gx/en/economic-crime-survey/index.jhtml>.

<sup>69</sup> *Ibid.*

<sup>70</sup> Paul Henninger, *Cyber Crime and Financial Crime: The Two Become One*, Nov. 15, 2013 *Wired Innovation Insights Blog* available at <http://insights.wired.com/profiles/blogs/cyber-crime-and-financial-crime-the-two-become-one#axzz37vUNNjaI>.

<sup>71</sup> Vikram Bhat & Lincy Francis Therattii, *Transforming Cybersecurity: New Approaches for an Evolving Threat Landscape 1* (Deloitte 2014) available at [http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/us\\_fsi\\_Transformingcybersecurity\\_021114.pdf](http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/us_fsi_Transformingcybersecurity_021114.pdf) (noting that cyber risk is now the world's third corporate risk priority overall in 2013).

<sup>72</sup> Phil Butler, *Cyber Crime, Financial Fraud and Money Laundering: Understand the new threat Landscape 1*, (Thomas Reuter Accelus 2013) available at <http://acceluscdn.thomsonreuters.com/accelus-pdf/GRC00331-Cybercrime-Phil-Butler.pdf>.

<sup>73</sup> *Ibid.*

<sup>74</sup> *Ibid.*

<sup>75</sup> Siobhan Gorman, *Annual U.S. Cybercrime Costs Estimated at \$100 Billion*, *Wall S. J.*, July 22, 2013 available at <http://online.wsj.com/news/articles/SB10001424127887324328904578621880966242990>

<sup>76</sup> Butler, *supra* note 575, at 1.

<sup>77</sup> Compare *Int'l Ass'n of Machinists & Aerospace Workers v. Werner-Masuda*, 390 F. Supp. 2d 479, 499 (D. Md. 2005) (stating that 18 U.S.C. § 2701 is directed against unauthorized users gaining access to protected computers rather than against authorized users gaining access for larcenous acts), with *Int'l Airport Ctrs., L.L.C. v. Citrin*, 440 F.3d 418, 420 (7th Cir. 2006) (“[18 U.S.C. § 1030] is concerned with attacks by virus and worm writers ... from the outside, and attacks by disgruntled programmers.”).

confidence;<sup>78</sup> (3) the dual system of prosecution;<sup>79</sup> and (4) the trouble of actual detection. Nevertheless, the common unique feature of cybercrimes is that they “are committed across cyber space and do not stop at the conventional state-borders. These crimes can be perpetrated from anywhere and against any computer user in the world.”<sup>80</sup> Cyber criminals often seek personal and financial data for fraudulent objectives.<sup>81</sup> Thus, cybercrimes has become an integral part of any discussion on fraud.<sup>82</sup>

The problem arises that many cyber criminals, who are located all over the world, are undeterred by the prospect of arrest or prosecution.<sup>83</sup> Cyber criminals are difficult to detect and pose one of the greatest threats to the financial health of businesses, to the consumer confidence, and to nations’ security.<sup>84</sup> Studies have also shown that the financial sector is the most attractive target to cyber criminals.<sup>85</sup> Large scale data breaches enable cyber criminals to access a great deal of information, and the proceeds of the act often are used to fund fraudulent activity such as terrorism and drug trafficking.<sup>86</sup> Businesses and entities at various levels have the need to create and maintain an online presence in order

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<sup>78</sup> Chris J. Hoofnagle, Identity Theft: Making the Known Unknowns Known, 21 HARV. J.L. & TECH. 97, 107 (2007) (arguing statistics on cybercrime are unconvincing due to victim reluctance on reporting); Bob Tedeschi, E-Commerce Report; Crime is Soaring in Cyberspace, but Many Companies Keep it Quiet, N.Y. TIMES, Jan. 27, 2003, available at <http://www.nytimes.com/2003/01/27/business/e-commerce-report-crime-soaringcyberspacebut-many-companies-keep-it-quiet.html> (identifying loss of consumer confidence as well as “fear of attracting other cyberattacks” and “inviting the ridicule of their competitors” as reasons companies fail to report computer crime).

<sup>79</sup> See Joseph M. Olivenbaum, Ctrl-Alt-Delete: Rethinking Federal Computer Crime Legislation, 27 SETON HALL L. REV. 574, 575 n.4 (1997) (arguing the dual system creates doubt in the cybercrime statistics).

<sup>80</sup> Communication from the European Commission to the Council and the European Parliament, creating a Safer Information Society by Improving the Security of Information Infrastructures and Combating Computer-Related Crime 9 (2000), available at <http://europa.eu.int/ISPO/eif/InternetPoliciesSite/Crime/CrimeCommEN.html> [hereinafter Creating a Safer Information Society].

<sup>81</sup> Mike McGuire & Samantha Dowling, Cyber Crime. A Review of the Evidence Research Report 5 (2013) available at <https://www.gov.uk/government/publications/cyber-crime-a-review-of-the-evidence>.

<sup>82</sup> Ibid.

<sup>83</sup> Marc D. Goodman and Susan W. Brenner, The Emerging Consensus on Criminal Conduct in Cyberspace, 2002 UCLA J. L. & TECH. 3 (2002).

<sup>84</sup> Ibid.

<sup>85</sup> See Economic Crime Survey, *supra* note 572, at 30 (finding that forty-five percent of financial services organization affected by fraud were also victims of cybercrime, which is three times as much as all other industries).

<sup>86</sup> See generally Kimberly Kiefer Peretti, Data Breaches: What the Underground World of "Carding" Reveals, 25 SANTA CLARA COMPUTER & HIGH TECH. L.J. 375 (2009) (discussing the connection between cyber financial crimes and other criminal activity).

to be successful in today's world.<sup>87</sup> Early on, the financial sector in particular took advantage of information and communication technology so that they could prepare the ground for borderless, around the clock global trading and offering of services.<sup>88</sup> Consequently, cyber financial crimes have become the world's third corporate-risk priority overall.<sup>89</sup> Financial services are the main targets for cyber criminals, and often fall victim to large data breaches which compromises personal financial information, such as credit or debit card account information, rather than other types of personally identifiable information, such as Social Security numbers.<sup>90</sup>

Although developing an international standard for addressing cybercrimes is difficult, considering the global nature of the threat to financial wellbeing of countries along with the national security issues leads to the idea that an attempt is needed. Measures aimed at targeting criminal proceeds and the prevention and control of fraud have not been sufficiently addressed in measures combating cybercrimes.<sup>91</sup> Connections between identity theft and terrorism have been established already.<sup>92</sup> Additionally, drug traffickers have also been known to engage in identity theft to finance their activities.<sup>93</sup> Criminals have found countless ways to exploit vulnerabilities and take advantage of financial institutions, businesses, and individuals in order to commit further crimes.<sup>94</sup> Therefore, stronger measures addressing these connections are needed to ensure prevention, detection and deterrence.

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<sup>87</sup> Financial Crimes: A Threat to Global Security 121 (Maximilian Edelbacher et al. 2012) [hereinafter Financial Crimes].

<sup>88</sup> Ibid.

<sup>89</sup> Vikram Bhat & Lincy Francis, Transforming Cybersecurity: New Approaches for an Evolving Threat Landscape 1, (Deloitte 2014) available at [http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/us\\_fsi\\_Transformingcybersecurity\\_021114.pdf](http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/us_fsi_Transformingcybersecurity_021114.pdf) (noting that cyber risk is now the world's third corporate risk priority overall in 2013)

<sup>90</sup> Kimberly Kiefer Peretti, Data Breaches: What the Underground World of "Carding" Reveals, 25 Santa Clara Computer & High Tech L.J. 375 (2009).

<sup>91</sup> Ibid

<sup>92</sup> Bob Sullivan, Your Evil Twin: Behind the Identity Theft Epidemic 122-40 (2004).

<sup>93</sup> Ibid. at 150-52.

<sup>94</sup> Money Laundering & Terrorist Financing Vulnerabilities of Commercial Websites and Internet Payment Systems, FATF (2008) available at <http://www.fatf-gafi.org/media/fatf/documents/reports/ML%20TF%20Vulnerabilities%20of%20Commercial%20Websites%20and%20Internet%20Payment%20Systems.pdf> (discussing the potential vulnerabilities of online commercial websites and payment systems)

Chapter 5 continues the analysis of banking compliance as a tool to promote stability and financial crime prevention. While regulatory agencies continue to issue new rules as a means to maintain safe and efficient markets, financial institutions are under fire in order to ensure compliance.<sup>95</sup> Compliance programs in the financial industry are under pressure to revamp compliance programs to meet the demands of federal, state and even international regulators.<sup>96</sup> An emphasis on compliance departments to become more involved in the businesses they work with has developed as a means to eliminate regulatory violations and to avoid fines, or reduce them in the event of an offence.<sup>97</sup> Regulators understand that financial crime rates are increasing<sup>98</sup> and that the role of compliance and control must evolve from simply observing the laws to a much more integrated approach to address the situation. Financial institutions understand the need to certify adherence with the relevant rules and regulations in order to grow, merge, and prosper.<sup>99</sup>

One important and positive aspect of compliance is that international organizations help in establishing the principles of compliance. However, this is not without problems as many of these principles fail to rise to the level of binding law and thus are not considered legal requirements, rather they are guidelines to a national governments compliance program.<sup>100</sup> Furthermore, there are no international treaties established to create binding

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<sup>95</sup> Melanie Grindle, Innovation in Legislative Measures to Prevent White Collar Crime, COLUMBIA BUS. L. REV., May 5, 2015, <http://cblr.columbia.edu/archives/13352> (finding that legislators and regulators have been initiating creative deterrents such as offender registry and rewarding employees who report illegal banking activity).

<sup>96</sup> Victoria Rivkin, After the Fall: The Rising Need for Compliance Lawyers in a Post-Financial Crisis World, 18 BROOK. L. SCH. LAW NOTES, Fall 2013, at 20, 21 (2013).

<sup>97</sup> Jennifer Smith, New Legal Pitfalls Abound--Cybercrime, Labor Rules, Financial Penalties Add to General Counsels' Concerns, WALL ST. J., Jan. 6, 2014, at B6; Daniel M. Gallagher, Comm'r, SEC, Remarks at the 2013 Nat'l Compliance Outreach Program for Broker-Dealers (Apr. 9, 2013), available at [http://www.sec.gov/News/Speech/Detail/Speech/1365171515226#UvAMT\\_shMuc](http://www.sec.gov/News/Speech/Detail/Speech/1365171515226#UvAMT_shMuc).

<sup>98</sup> See Ginny Grimsley, why is White-Collar Crime on the Rise? River Cities' Reader, Aug. 20, 2012, <http://www.rcreader.com/news-releases/why-is-white-collar-crime-on-the-rise/> (noting that white-collar crimes in the United State alone has increased by 17.8 percent).

<sup>99</sup> Nick Allard, Why Compliance Experts Are the New Key to Mega-Deals, YAHOO! FINANCE (July 15, 2013, 3:19 PM), <http://finance.yahoo.com/blogs/the-exchange/why-compliance-experts-key-mega-deals-191921713.html>.

<sup>100</sup> See. Basel Comm. on Banking Supervision, Bank for Int'l Settlements, A Brief History of the Basel Committee 1 (2013), available at <http://www.bis.org/bcbs/history.pdf> [hereinafter Basel Comm. History] ("The Committee's decisions have no legal force.").



agreements between countries who participate in these international principles.<sup>101</sup> Compliance principles established by international organizations such as the Basel Committee on Banking Supervision (“BCBS”), which is “hosted” by the BIS,<sup>102</sup> have no real effect. Rather Basel law and other compliance principal exist primarily to guide national implementation. The form of national implementation--whether by statute, regulation, guidelines or whatever--is left to national discretion.<sup>103</sup>

This can be clearly problematic in spill over situations. While some countries may implement compliance standards in the most effective way possible to suit their needs, other countries may not. Thus when financial crimes begin to wreak havoc in the system, a spill over may occur, resulting in negative effects throughout the international community. Although agencies and institutions continue to produce regulations and emphasize compliance, the financial system is suffering from a lack of adherence to these rules, jeopardizing the stability of the global market. Recent scandals over the years demonstrate that there is a deficiency in ethical behaviour and lack of compliance in the culture of the financial sector. Policy makers around the world need to rethink the goals of regulation, including the means and purpose behind the regulations. Resolution of the issues that continue to appear requires the establishment of a common standard of what constitutes responsibility and simultaneous clarification of requisite accountability structures. Improved global integration allows for financial institutions to better manage risks on a global basis. The world is not functioning on national levels and compliance and oversight must address this otherwise instability can overspill into the global market.

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<sup>101</sup> Keren Alexander, Global Financial Standard Setting, The G10 Committees, and International Economic Law, 34 *BROOK. J. INT'L L.* 861, 876 (2009) (“As an international legal matter, the Basel Capital Accord and its amended version, Basel II, are not legally binding in any way for G10 countries or other countries that adhere to it. The Capital Accord has been analyzed and classified as a form of ‘soft’ law.”).

<sup>102</sup> Basel Committee on Banking Supervision, Bank for Int'l Settlements, <http://www.bis.org/bcbs> (explaining the Committee “provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide”).

<sup>103</sup> Alexander, *supra* note 890, at 874.

Chapter 6 of this thesis will examine Islamic financial institutions and their possible role in promoting stability. Islamic banking is present today in over 55 countries around the world. Despite this consistent growth, many supervisory authorities and finance practitioners remain unacquainted with the operations of the Islamic banking especially in the U.S. This thesis will provide an overview of the Islamic finance industry, describe the products and services offered, as well as the legal framework behind Islamic banking. Furthermore, this chapter will discuss the legal and regulatory challenges to promote the development of Islamic banking since “there is no financial system isolated and there are few players in the financial world that retain the privilege of an entirely domestic business environment and thus not exposed to the risks of legal systems and their courts.”<sup>104</sup>

This concept demonstrates the importance of using resources efficiently “in order to bring about the most superior outcome, and that human beings should achieve God’s aim and facilitate the dissemination of good fortune and earth as well as the hereafter.”<sup>105</sup> This model tremendously affects wealth ownership and its generation and it motivates every Muslim to get involved in economic activity and to enhance their confidence with the goal accomplishment.<sup>106</sup> This basis has become the argument for the reasons why Islamic banking should replace conventional banking. The aspect of Islamic banking most emphasized in this thesis is the prohibition of interest (*Riba*) and *zakat*. Interest, according to Islamic economist is a theoretical concept that does not produce real growth of capital.<sup>107</sup> It has been interpreted as a form of exploitation and injustice and thus is contrary to Islamic principles of fairness and property rights.<sup>108</sup> *Zakat* is third of the five pillars of Islam, the word means “purity” and “cleanliness” and the notion is that one purifies their wealth as well as one’s heart by giving away a portion of their wealth to the poor.<sup>109</sup> *Zakat* generally means that 2.5% of the wealthy individual’s wealth is distributed to the poor every year.

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<sup>104</sup> Barry A.K Rider “Islamic Finance Law & Practice” Oxford University Press Corporate Governance for Institutions offering Islamic Finance Services P.172.

<sup>105</sup> Ibid.

<sup>106</sup> Ibid.

<sup>107</sup> Imtiaz A. Pervez, *Islamic Finance*, 5 ARAB L.Q. 259, 263 (1990).

<sup>108</sup> Brian Kettell, *Introduction to Islamic Banking and Finance* 32 (2011).

<sup>109</sup> Hans Visser, *Islamic Finance: Principle and practice* 31 (Edward Elgar ed., 2nd ed. 2013)

Although Islamic banks are covered by the same laws as conventional banks when they are outside of Islamic countries, and not treated distinctly, the *Shari'a* compliance and Islamic banking raises several issues regarding compliance risk and money laundering in particular. Terrorist financing quickly became linked to the Islamic financial system given that many charitable organizations were found to be utilizing reverse money laundering, using clean money to finance criminal activity or terrorism.<sup>110</sup> This creates a difficult situation given compliance departments and monitoring software is attempting to follow the cash flow from its criminal activity, such as drug trafficking, as it is “washed” and aimed for legitimate uses in the traditional sense of money laundering.<sup>111</sup> This method used by terrorist throws a loop in the system since perfectly legitimate money is used and then wired or transferred to terrorists.<sup>112</sup> Hence, the use of financial crimes in Islamic banking can be even more difficult to detect and combat. Finally, this chapter will turn to means of combating financial crimes in the Islamic financial system and promoting financial stability.

Chapter 7 examines corruption and stolen asset recovery and the role for the IFIs in promoting stability. Professor Barry A.K. Rider writes, “The nature of corruption is more insidious than many other forms of economic crime.”<sup>113</sup> International law has turned its focus to corruption and the recovery of stolen assets.<sup>114</sup> Although corruption is found in countries all over the world, developing countries and those in transition are the ones that are most affected by the harms of corruption.<sup>115</sup> Corruption is considered to be the abuse of power for personal gain. A more frequently used definition of corruption “is the abuse of public office for private gain.”<sup>116</sup> In the words of the World Bank’s General Counsel,

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<sup>110</sup> Stefan D. Cassella, Reverse Money Laundering, 7 J. Money Laundering Control 92, 92 (2003).

<sup>111</sup> See generally Eric J. Gouvin, Bringing out the Big Guns: The USA Patriot Act, Money Laundering, and the War on Terrorism, 55 BAYLOR L. REV. 955 (2003)

<sup>112</sup> Ibid.

<sup>113</sup> Barry A.K. Rider, Corruption: The Enemy Within, p. 3. (Kluwer law International 1997)

<sup>114</sup> Jean-Pierre Brun et, al. Public Wrongs, Private Actions: Civil Lawsuits to recover stolen assets (Stolen Asset Recovery Initiative, The World Bank, 2014).

<sup>115</sup> Larissa Gray et., Few and Far: The Hard Facts on Stolen Asset Recovery 1 (Stolen Asset Recovery Initiative, The World Bank, 2014) (discussing that corruption slows economic growth and development, affects the quality and accessibility of public services and infrastructure, erodes public confidence in government, reduces private sector development and weakens the rule of law).

Ibrahim Shihata, “Corruption occurs when a function, whether official or private, requires the allocation of benefits or the provision of a good or service. In all cases, a position of trust is being exploited to realize private gains beyond what the position holder is entitled to. Attempts to influence the position holder, through the payment of bribes or an exchange of benefits or favors, in order to receive a special gain or treatment not available to others is also a form of corruption, even if the gain involved is not illicit under applicable law. The absence of rules facilitates the process as much as the presence of cumbersome or excessive rules does. Corruption in this sense is not confined to the public sector and, in that sector, to administrative bureaucracies. It is not limited to the payment and receipt of bribes. It takes various forms and is practiced under all forms of government, including well-established democracies. It can be found in the legislative, judicial, and executive branches of government, as well as in all forms of private sector activities. It is not exclusively associated with any ethnic, racial, or religious group. However, its level, scope, and impact vary greatly from one country to another and may also vary, at least for a while, within the same country from one place to another. While corruption of some form or another may inhere in every human community, the system of governance has a great impact on its level and scope of practice. Systems can corrupt people as much as, if not more than, people are capable of corrupting systems”. When perpetrated by public officials, these abuses are considered public wrongs.<sup>117</sup> Scholars from all over consider corruption to be a universal phenomenon.<sup>118</sup> As can be imagined, corruption has been found to cause a number of negative impacts in the world.<sup>119</sup> Although it seems virtually impossible to rid

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<sup>117</sup> William Blackstone, *Commentaries of the Laws of England*, bk. 4, Ch. 1, Of the Nature of Crimes; and Their Punishment 1765–69 (“breaches and violations of duties due to the whole community, considered as a community, in its social aggregate capacity”)

<sup>118</sup> Corruption International Business: The challenge of cultural and legal diversity. 179-80 (Sharon Eicher ed., 2008).

<sup>119</sup> Claes Sandgren, *Combating Corruption: The Misunderstood Role of Law*, 39 INT'L LAW. 717, 730, (2005) (finding that corruption causes poverty.); Daniel Kaufmann et al., *Governance Matters* (The World Bank Development Research Group Macroeconomics and Growth & World Bank Institute Governance, Regulation and Finance, Working Paper No. 2196, 1999), <http://siteresources.worldbank.org/intwbigovantcor/resources/govmatrs.pdf> (establishing that corruption reduces private investment), Elizabeth Spahn, *International Bribery: The Moral Imperialism Critiques*, 18 MINN. J. INT'L L. 155, 224-25 (2009) (discussing how corruption frustrates efforts to achieve human rights).

the world of corruption, the international community has formally condemned it and continues to make efforts in order to suppress and deter it.<sup>120</sup>

While the definition stated above is generally accepted, corruption can be an eluding word and difficult to define due to the fact its meaning derives primarily from cultural norms.<sup>121</sup> The meaning of “corruption” can therefore shift depending on the speaker.<sup>122</sup> Over the years, anticorruption efforts focus on the fight against administrative corruption.<sup>123</sup> Administrative corruption involves the payment of small-scale bribes to mid and low level government officials.<sup>124</sup> The anticorruption focus today has shifted to grand corruption. Grand corruption, also known as political corruption, involves large bribes given in connection with major interactions, such as large infrastructure projects or arms sales, and the abuse of political power to extract and accumulate for private gain.<sup>125</sup> The key difference between these types of corruption is that “administrative corruption reflects specific weaknesses within different systems, while grand corruption involves the distortion and exploitation of entire systems for the benefit of private interests.”<sup>126</sup> Grand corruption is often associated with the massive redirection of public funds for the private use of the political elite.<sup>127</sup> The most notorious culprits have stolen billions of dollars from their countries for their own personal wealth accumulation.

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<sup>120</sup> Winfield Bean, *Hyperbole, Hypocrisy, and Hubris in the Aid-Corruption Dialogue*, 41 *GEO. J. INT'L L.* 781, 786 (2010)

<sup>121</sup> Cf. *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Supreme Court Justice Potter Stewart once declared that although he could not define pornography, he knew it when he saw it)

<sup>122</sup> See Susan Rose – Ackerman, *Governance and Corruption*, in *Global Crises, Global Solutions* 301 (Bjorn Lomborg, ed., 2004).

<sup>123</sup> Mary Evans Webster, *Fifteen Minutes of Shame: The Growing Notoriety of Grand Corruption*, 31 *Hastings International & Comp. L. Rev.* 807, 808 (2008).

<sup>124</sup> Claes Sandgren, *Combating Corruption: The Misunderstood Role of Law*, 39 *INT'L LAW.* 717, 723 (2005)

(noting mid and low level government officials included police officers, customs personnel, medical doctors, and teachers).

<sup>125</sup> U4 Anti-Corruption Resource Center; *What is Political Corruption?* available at <http://www.u4.no/themes/political-corruption/introduction.cfm#definitions>.

<sup>126</sup> Steven E. Hendrix, *New Approaches to Addressing Corruption in the Context of U.S. Foreign Assistance with Examples from Latin America and the Caribbean*, 12 *SW. J. L. & TRADE AM.* 1, 4 (2005).

<sup>127</sup> *Ibid.*

Asset recovery has developed into a critical tool in combating transnational corruption.<sup>128</sup> However, the utilization of asset recovery is filled with both legal and practical difficulties.<sup>129</sup> Moreover, while there are significant amounts of money involved, recovering stolen assets does not always simply focus on money. Deterrence and retribution should also become a focus of these efforts. The success of asset recovery can often depend on the regulation of the financial sector.<sup>130</sup> Financial regulations complement and strengthen the anti-corruption instruments, although they have also been seen to contradict each other on certain issues.<sup>131</sup> However, asset recovery and combating corruption is accomplished with countries and international financial institutions working on having the persons involved in corruption being held criminally or civilly liable (with a focus on the individual), but also the proceeds from their corrupt acts can also be seized (with a focus on the assets).<sup>132</sup>

Chapter 8 examines international financial institutions' sanctions regime as a tool to promote financial stability. In 2006, as a means to harmonize efforts in combating financial crimes and to create a joint sanctions system against corruption and fraud, the multilateral development banks ("MDBs"),<sup>133</sup> along with the International Monetary Fund and the European Investment Bank (EIB), formed the International Financial Institutions Anti-Corruption Task Force ("the Task Force"). The Task Force became the first real step in unifying the international financial institutions in their efforts against corruption and

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<sup>128</sup> Thomas R. Snider & Won Kidane, *Combating Corruption Through International Law in Africa: A Comparative Analysis*, 40 CORNELL INT'L L.J. 691, 741 (2007).

<sup>129</sup> Vlasic & Cooper, *supra* note 1200, at 3 (listing such difficulties as insufficient legal precedent, lack of cooperation from offshore financial centers, and domestic interference encountered in asset recovery).

<sup>130</sup> Jan Wouters et. al., *The International Legal Framework Against Corruption: Achievements and Challenges*, 14 MELB. J. INT'L L. 205, 261 (2013).

<sup>131</sup> Cf. Indira Carr and Miriam Goldby, *Recovering the Proceeds of Corruption: UNCAC and Anti-Money Laundering Standards*, 2 J. of Bus. L. 170, 180. (2011) (indicating that the FATF recommendations may conflict with the UNCAC provision as to the requirement of double criminality);

<sup>132</sup> Jan Wouters et. al., *The International Legal Framework Against Corruption: Achievements and Challenges*, 14 MELB. J. INT'L L. 205, 261 (2013).

<sup>133</sup> The multilateral development banks (MDBs) include the African Development Bank Group (consisting of the African Development Bank, the African Development Fund, and the Nigeria Trust Fund), the Asian Development Bank, the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank Group (consisting of the Inter-American Development Bank, the Inter-American Investment Corporation, and the Multilateral Investment Fund), and the World Bank Group (WBG) (consisting of the International Bank for Research and Development (IBRD), the International Development Association (IDA), the International Finance Corporation, and the Multilateral Investment Guarantee Agency).

financial crimes.<sup>134</sup> The document, the Uniform Framework for Preventing and Combating Fraud (“Uniform Framework”) harmonized definitions for sanctionable practices to be used by the participating financial institutions. It also contained a commitment to harmonize the investigative procedures and also explore whether debarment decisions from one institution should be recognized by the others. The Uniform Framework recognizes four sanctionable practices: corrupt practice, fraudulent practice, coercive practice, and collusive practice.

Finally, Chapter 9 concludes by supporting the outcome of this research and supporting the proven hypothesis, it details what has been accomplished and highlights the restraint of this research.

Since the end of World War II and the creation of International Monetary Fund (IMF) and the International Bank for Reconstruction and Developments (“World Bank”) at Bretton Woods, New Hampshire in 1944, the focus of development theory and professionals largely has been on design and implementation of appropriate policies supported through aid and assistance, culminating in pre-eminence of the so called Washington Consensus of stabilization, liberalization and privatization.<sup>135</sup>

In evaluating the last 20 years of policies and practices set forth by IFIs in promoting stability, it is clear that a lot of work needs to be done. While these institutions aimed at tackling financial crimes and highlighting different approaches in the various jurisdictions, there is insufficient research into the study of the effectiveness of their role in promoting stability in the face of the financial misconduct such as fraud and insider dealing, corruption and money laundering, etc. This thesis, thus, seeks to fill the gap by analysing the International Financial Institutions (IFIs)’s role, while considering the

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<sup>134</sup> Uniform Framework for Preventing and Combating Fraud and Corruption [hereinafter Uniform Framework], available at <http://www.ebrd.com/downloads/integrity/task.pdf>.

<sup>135</sup> P. Krugman, “Dutch Tulips and Emerging Market”, *For. Affairs*, Jul/Aug. 1995. p.28. Krugman describes the so-called “Washington Consensus” regarding economic policies that developed in the early 1990s.

literature and practice generally on evaluating their role which have not received adequate attention.

The principle hypothesis tested is that: International Financial Institutions (IFIs) can contribute considerably to the financial stability in the face of financial misconduct by tackling financial crimes. Unfortunately, the literature on this subject has not progressed significantly beyond the date of this writing. Thus, what sort of development and improvement to the role of IFIs will be added? This thesis attempts to answer the question in the context of analysing each of financial misconduct in comparative way between different jurisdictions mainly in the U.S and the UK.

### **IMF and Regulation**

The globalization of trade and financial markets and the associated liberalization of international capital markets may be the most important economic development of the late 20<sup>th</sup> Century. The benefits can be measured ultimately in higher standards of living, as resources are allocated with increased efficiency and risk sharing is improved. However, the increased volume volatility of capital flows has exposed vulnerabilities in recipient countries, often in the form of the unsound financial and banking systems and deficiencies in financial incentive structures, institution and policies. While the long term benefits of financial liberalization and globalization are not in doubt, the intensified market discipline over financial institutions and the frequency of financial sector problems in a range of countries have underscored the need for countries to move quickly to implement international best practices in financial supervision and regulation.<sup>136</sup>

In early 1997, a G-10 Working Party presented a report to the G-7 Finance Ministers outlining the key aspects of a sound financial sector and a market strategy for promoting financial stability. In this same period, the Basle Committee on Banking and Supervision developed its Core Principles of Effective Banking Supervision. At the Denver Summit, the G-7 Finance Ministers ask the IMF and The World Bank to help encourage

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<sup>136</sup> Address by Stanly Fisher, First Deputy Managing Director of the international Monetary Fund at the Conference on Financial Stability and Prudential Standards, Hong Kong, September 22, 1997.



their members to adopt appropriate principles and guidelines in these areas. Moreover, the IMF has been encouraged to assist in detecting and preventing financial sector problems by strengthening its surveillance of the finance sector.<sup>137</sup>

Besides financial crimes, a banking crisis is among the most damaging influences on economic growth and development prospects and stability. One way that the IMFs have helped countries avoid banking crisis is through the Financial Sector Assessment Program (FSAP), which is jointly managed by the IMF and the World Bank. Started after the 1999 economic crises in East Asia and Russian Federation, FSAP is a diagnostic exercise which looks at the vulnerabilities and financial sector impediments to growth. From 1999-2009 more than 140 FSAPs were or ministers of finance. (IMF 2012) Long before the current crisis raised concerns about the quality of banking supervision, FSAPs were helping countries to identify and deal with banking problems, and central bankers privately praised the exercise and stressed its importance.<sup>138</sup> The Assessment of the financial sector standards is the other significant part of the overall assessment of the financial system. The focus of the FSAP is on three areas: Financial sector regulation and supervision, Institutional and market infrastructure, Policy transparency.<sup>139</sup>

The International banking standards devised by Basel Committee are a significant part of FSAP process, which adapts Basel Committee methodology to evaluate compliance with the Core principles. Through the assessments a number of issues have over time been identified which would call in to question the effectiveness of the regulatory regime in a country. Examples may include: political interference in the authorization process or lack of legal immunity of law suits; a lack of powers to deal with unauthorized activities; a lack of criteria to ascertain whether a bank or shareholders or individual director are fit and proper; capital adequacy rules which are not adhered to or monitored effectively on either an individual bank basis or consolidated basis; large exposures which are not monitored or reported; insufficient on site- assessment of banks; limited consolidated supervision of

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<sup>137</sup> Ibid.

<sup>138</sup> The Role and Influence of IFIs. Danny Leipziger Chapter 49 Page 9.

<sup>139</sup> The Role of the IMF and the World Bank in Financial Sector Reform and Compliance, By Dalvinder Singh.

cross-sector or cross-border activities; ineffective enforcement by the regulators of standards of rules that actually exist; and limited cooperation between respective to oversee banks that operate across borders.<sup>140</sup>

The IMF with its near universal membership of the world's countries has an important role to play in these international efforts to promote financial sector stability, not just in the emerging markets but across the entire membership. In its individual country surveillance with members, the Fund seeks to improve the macroeconomic environment and policies through its regular consultation discussion. In addition to assessing the macroeconomic implications and on suggesting corrective policy steps, the IMF surveillance promotes a financial sector policy framework consistent with internationally accepted standards, as developed by the supervisory community and other bodies; it also assesses its implications.<sup>141</sup>

In its multilateral surveillance- primarily through the World Economic Outlook and the International Capital Markets exercises- the Fund seeks to identify financial vulnerabilities and risks with a potential for generating regional and international spillovers. This work involves identifying deficiencies in areas such as: systemically important banking systems; international aspects of financial supervision and regulation; the design and operation of wholesale payments systems; and functioning of the financial infrastructures underlying the major international financial markets.<sup>142</sup> The Fund supports adjustment programs which often include conditionality related to financial sector reforms, such as legal and regulatory improvements, systemic bank restructuring privatization of banks, and the introduction of appropriate monetary instruments and market based systems of monetary management. The Fund also provides technical assistance, at the request of members, focusing on central banking (including central bank and banking legislation), and the design and development of monetary, foreign exchange, and public debt markets and instruments. Also, payment systems and public sector guarantee arrangements;

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<sup>140</sup> Ibid.

<sup>141</sup> Ibid.

<sup>142</sup> Ibid.

reporting and disclosure requirements; and linkages between banking system and fiscal policies.<sup>143</sup> The IMF staff is developing a general framework for identifying the strengths and weaknesses of financial system and has produced a distillation of widely accepted views of what might constitute a framework for financial stability, focusing on banking soundness and pinpointing the deficiencies that have frequently led to macroeconomic repercussions.<sup>144</sup> In which will be examined in more depth throughout this thesis.

The IMF's efforts are intended to raise the general awareness of authorities in member countries to the potential macroeconomic consequences of unsound financial systems, to promote principles of financial sector soundness, and offer appropriate solutions to problems in selective cases where financial weakness may become a major concern. Of course, the fund is neither a rating agency nor banking supervisor and cannot be in the business either of certifying that a country's financial sector is safe and sound or alternatively of making adverse judgments on these issues. Further, the Fund surveillance cannot address all of the areas in the financial system that may need improvement, nor can it be expected to provide specific assistance to the regulatory and supervisory authorities in meeting their day to day challenges.<sup>145</sup> The World Bank and the IMF policies, which hadn't changed much in the past decade, seemed more concerned with social policies and anti-corruption efforts and tackling financial crimes which will be the focus of this thesis.

## **Islamic Banking**

Another aspect of this thesis deals with Institutions offering Islamic financial services which constitute a significant and growing share of financial system in number of countries.<sup>146</sup> Since the inception of Islamic Banking about three decades ago, the number and reach of Islamic financial institutions worldwide has risen from one institution in one country in 1975 to over 300 institutions operating in more than 75 countries.<sup>147</sup> Reflecting

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<sup>143</sup> Ibid.

<sup>144</sup> Ibid

<sup>145</sup> Ibid.

<sup>146</sup> IMF working Paper "Islamic Banks and Financial Stability: An Empirical Analysis" Martin Cihak and Heiko Hess.

<sup>147</sup> El Qorchi, M. "Islamic Finance Gears Up," IMF, Finance and Development, 42. 2005.

the increase role of Islamic Finance, the literature of Islamic Banking has grown. This thesis attempts to fill the gap in the empirical literature on Islamic banking and analyzing the issue of a cross-country context empirical analysis of the role of the Islamic banks in promoting financial stability.

The rise of Islamic finance in the global arena can be partly attributed to the global financial crises of 2007-2009, where complex financial instruments nearly caused the collapse of Western Banking. Another reason is the need for political inclusion after 9/11. In the recent years, the benefits and ethical aspects of Islamic financial instruments have increasingly come to light. In particular relevance to developing countries, Islamic financial instruments and services may better serve the interests of many developing economies than traditional forms of finance in terms of its shared attributes with ethical or socially responsible investment and its suitability for funding for public infrastructure projects, but challenges still remain for acquiring expertise to build sound risk management framework. The foundation of Islamic finance as distinct from traditional financial services will first be briefly illustrated.

Furthermore, Chapter 6 will focus on how and the extent to which multilateral institutions and the governments of developing countries are engaging with Islamic finance, and particular set of advantages, obstacles, as well as associated with each initiative. In the years following the financial crisis, financial institutions have recognized that crucial to bank stability and maintenance to the overall health of the financial system is the diversity of services offered to different industries and costumers.<sup>148</sup> One of these services is Islamic Financial Assets, which though currently only accounting for less than 1% of the total global financial assets,<sup>149</sup> comprises of the fastest growing areas in finance as to become firmly embedded in global political and economic order.<sup>150</sup> A joint report

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<sup>148</sup> Lindblom, T, Sjogren, S and Willeson. M 2014. 'Challenges for Banks and New Regulatory Framework', ch.1 in Governance, Regulation and Bank Stability, Palgrave Macmillan, Houndmills, Basigstock, Hampshire.

<sup>149</sup> Di Mauro, F, Caristi P, Couderc, S, Di Maria, A, Ho, L, Grewal, Bk, Masciantonia, S, Ongena, S & Zaher, S, 2013, 'Islamic Finance in Europe', Occasional Working Paper Series, no. 146. European Central Bank. Available from: <https://www.ecb.europa.eu/>. [April 2016]

<sup>150</sup> Warde, I 2000 Islamic Finance in Global Economy, Edinburgh University Press, Edinburgh, UK.

among the Islamic Financial Service Board (IFSB), Islamic Development Bank, and Islamic Research and Training Institute in 2010 confirms the “increased initiatives to acquire strategic stakes in Islamic financial institutions in different parts of the world, “helping to promote productive economic activity and inclusive development.

In 2010, efforts to combat crimes were strengthened when the MDBs decided to sign the Agreement for Mutual Enforcement of Debarment Decisions (“Mutual Enforcement Agreement”).<sup>151</sup> This significantly enhanced the sanctions regime that the MDBs would impose. Any entity found to have engaged in any of the practices recognized by the MDBs which results in debarment will be enforced by the other participating MDBs. The MDBs took further steps to harmonize their efforts in 2012 as well.

The first document, signed by the five MDBs, along with the EIB, was done in order to “harmonize their respective sanctioning guidelines, to ensure consistent treatment of individuals and firms.”<sup>152</sup> After reviewing certain aspects of the Mutual Enforcement Agreement, the document recognizes the sanctions discussed above that may be imposed singularly or in combination. In introducing the sanctions of conditional non-debarment and debarment with conditional release into the MDB harmonized regime, there was a strong incentive for entities and individuals to work on improving compliance measures.

Although the MDBs have made progress in moving forward with major harmonization in areas, there is more that can be addressed to further their efforts and unify their goals. For instance, the MDBs should consider harmonizing efforts in aiding local governments take on corruption challenges themselves. Transparency as well can be harmonized in terms of the amount of information that is made publicly available by the MDBs. The MDBs have a challenging order – they must provide financial support to developing countries, particularly with regard to those with rampant corruption, while at

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<sup>151</sup> Agreement for Mutual Enforcement of Debarment Decisions, 9 April 2010, available at <http://www.ebrd.com/downloads/integrity/Debar.pdf>. The Agreement was signed by AFDB, ADB, EBRD, EIB, IADB, and WB.

<sup>152</sup> General Principles and Guidelines for Sanctions, available at [http://lnadbg4.adb.org/oai001p.nsf/0/CE3A1AB934F345F048257ACC002D8448/\\$FILE/Harmonized%20Sanctioning%20Guidelines.pdf](http://lnadbg4.adb.org/oai001p.nsf/0/CE3A1AB934F345F048257ACC002D8448/$FILE/Harmonized%20Sanctioning%20Guidelines.pdf)

the same time attempting to safeguard the efficient use of those funds when they are no longer in control by the MDBs. The sanctions regime is a great step towards fighting corruption and aiding in creating financial stability. The MDBs however, need to examine their aims and how they are achieved. Greater due diligence is required to ensure these international financial institutions are doing their best in assisting in asset recovery and convicting corruption. As other aspects in the financial system, more can be done, implemented and harmonized in order to further the fight corruption and financial crimes.

## **Conclusion**

As explained, from the foregoing review of literature about the role of International financial institutions in promoting stability on the face of financial misconduct, that there is a lack in depth research on issues relating to regulations, governance and polices that need to be improved, as well we must ensure that the IFIs have power to perform their functions effectively. Therefore, this thesis not only to fill in the research the gap in the study, but also to recommend improvements for the current IFIs polices to promote stability. While this thesis examines the issues of International Financial Institutions 'role in promoting stability in the face of the financial misconduct such as: insider dealing, money laundering, cybercrimes from legal prospective, it is not however, within the limitation of this research to empirically establish whether the issues are indeed generally problematic in function of IFIs.

As it has been mentioned, financial stability is essential for national and international overall economic growth. This thesis will argue that further market reform is needed to enhance the fight against financial crimes that continue to be on the rise. In more recent years, financial market reform has mainly focused on the threats to financial stability that arise from legal activities in the financial industry characterized by excessive risk taking, distortive incentives, and the lack of controls in the overall regulatory financial work.<sup>153</sup> Although these issues do indeed need to be addressed, the threat to the economic and financial security caused by illegal financial activities cannot be ignored and more

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<sup>153</sup> Financial Crimes: A threat to Global Security, xvii (ed. Maximillian Edelbacher et al., 2012)

focus should be had on them. These crimes often can occur more easily due to the lack of regulation and weak supervision of the activities of the financial sector.

The next decade may well be more active roles for the IFIs in the evolution of promoting financial stability. Accordingly, it is of relevance to produce views on the problem and increase the amount of the literature. Putting things into more specific prospective, next chapter, I will start analysing Insider dealing, which is considered one of the biggest threats to the financial stability.

## CHAPTER 2

### INSIDER DEALING

#### Introduction

Insider dealing is considered to be one of the biggest threats to financial stability. One of the cornerstones of a fair, open and transparent market is the prohibition of the use of material non-public information. This prohibition goes to the core of the role market participants play in maintaining the integrity of markets.<sup>154</sup> Over the last several years, there has been coverage of financial scandals from all over the world, particularly regarding insider trading, as it is known in the United States or insider dealing as it is known in other countries.<sup>155</sup> Although there is no uniform definition of insider dealing, it generally refers to the buying or selling of a publicly traded company's stock based on material, non-public information about a particular company.<sup>156</sup> In recent years, most jurisdictions have enacted legislation that specifically deals with the problem of directors and officers of companies taking advantage of information that they receive by virtue of privileged positions by dealing in their company securities.<sup>157</sup>

The United States is the forerunner in combating insider dealing, and has influenced other countries regarding implementing legislation and banning at least some forms of insider dealing.<sup>158</sup> In the United Kingdom, insider dealing can be defined as trading in organized securities markets by persons in possession of materials non-public information

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<sup>154</sup> See Insider Trading Laws and the Role of Security Analyst, By: Michael S. Caccese / Financial Analyst Journal Vol. 53, No. 2 (March-April., 1975) pp 9-12

<sup>155</sup> See, e.g., Jane Croft & Brooke Masters, Ex - Cazenove Partner Guilty on Five Counts of Insider Dealing, Fin. Times, Mar. 11, 2010, at 16 (reporting on an insider trading conviction in London); Tom Mitchell, Du Trial is Evidence of How Watchdog is Showing More Bite, Fin. Times, Sept. 11, 2009, at 14 (detailing insider dealing prosecution in Hong Kong); Andrew England & Abeer Allam, First Insider Trader is Jailed in Saudi, FIN. TIMES, Aug. 18, 2009, at 19 (describing the first insider trading criminal prosecution in Saudi Arabia).

<sup>156</sup> Robert E. Wagner, Gordon Gekko to the Rescue? Insider Trading as a Tool to Combat Accounting Fraud, 79 U. CIN. L. REV. 973, 974 (2011).

<sup>157</sup> Professor Barry Rider. Dr. Keren Alexander, Stuart Bazley and Jeffrey Bryant 'Market Abuse and Insider Dealing' –third edition- p 1. (Bloomsbury Professional Ltd, 2016)

<sup>158</sup> Edward Greene & Olivia Schmidt, Duty-Free Insider Trading? 2013 COLUM. BUS. L. REV. 369, 371 (2013) (noting that there is legal and illegal insider dealing).



and has been recognized as a widespread problem that is extremely difficult to eradicate.<sup>159</sup> It has not been until recently that countries such as the United Kingdom have made more robust efforts in enforcing and prohibiting insider-dealing violations.<sup>160</sup> While the approaches to handling and combating insider dealing and securities fraud may differ in each country, the need and pressure to prosecute violators is increasing, as it is clear that insider dealing is still alive and well.<sup>161</sup> The perception that the insider abuse is still a major issue in most markets and traditional approach of the criminal law has not served as a significant deterrent and has led regulators such as the Financial Services Authority and the US Securities and Exchange Commission to renew their commitment to ‘stamp out’ insider dealing by whatever means are at their lawful disposal.<sup>162</sup>

This Chapter will compare and analyse the insider dealing regulations in both the United States and United Kingdom, by beginning with the development of the laws of securities fraud and insider dealing in the United States.<sup>163</sup> Then this chapter will discuss the laws of insider dealing in the United Kingdom.<sup>164</sup> A review of recent case law in both countries will follow in order to examine the differences in the U.S. and U.K. laws.<sup>165</sup> This chapter will also comment on some strengths and weakness of each regime,<sup>166</sup> and examine whether each provides sufficient protection for the investor and the markets.<sup>167</sup> Finally, the chapter will give a brief conclusion.<sup>168</sup>

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<sup>159</sup> *Ibid.*

<sup>160</sup> Jamie Syminton, Head of Wholesale Enforcement, FSA, Speech at the City and Financial Market Abuse Conference: Challenging the Culture of Market Behavior (Dec. 4, 2012), available at <http://www.fsa.gov.uk/library/communication/speeches/2012/1204-js> (“the [Financial Services Authority] has become a visible and credible force combating insider dealing. [It is] determined to crack down on market abuse and capable of doing so”).

<sup>161</sup> SEC Enforcement Actions: Insider Trading Cases, available at <https://www.sec.gov/spotlight/insidertrading/cases.shtml> (noting that in the past three years, the SEC filed more insider trading actions (168 total) than in any three-year period in the Commission's history).

<sup>162</sup> Professor Barry Rider, Dr. Keren Alexander, Stuart Bazley and Jeffrey Bryant “Market Abuse and Insider Dealing/third edition/ at vii. (2016).

<sup>163</sup> *See infra* discussion II.

<sup>164</sup> *See infra* discussion III.

<sup>165</sup> *See infra* discussion IV.

<sup>166</sup> *See infra* discussion V.

<sup>167</sup> *Ibid.*

<sup>168</sup> *See infra* discussion VI.

## United States

### Securities Fraud

Securities fraud is regulated through the Securities Act of 1933<sup>169</sup> (“1933 Act”) and the Securities Exchange Act of 1934<sup>170</sup> (“1934 Act”). Although the 1933 Act targets the primary market while the 1934 Act target the secondary market, both Acts have the same goal in mind which is to ensure market competition by requiring full and fair disclosure of all material information in the marketplace.<sup>171</sup>

The primary provisions that are used for criminal prosecution of securities fraud are Rule 10b-5<sup>172</sup> and § 32(a) of the 1934 Act.<sup>173</sup> Section 10(b) of the 1934 Act provided the basis for Rule 10b-5 and gave rise to a securities fraud claim.<sup>174</sup> When there is a wilful violator of § 10(b), the Security Exchange Commission’s (“SEC”) rules, or other provisions of the Acts, then § 32(a) can impose criminal liability.<sup>175</sup> Both private individuals as well as the federal government can make a securities fraud claim.<sup>176</sup> The laws of securities fraud have developed mostly due to judicial construction.<sup>177</sup> Securities fraud generally encompasses two forms of fraud: the first form is material

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<sup>169</sup> Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2006).

<sup>170</sup> Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78oo (2006 & Supp. III 2009).

<sup>171</sup> Allyson Poulos, Rachel Cox, Claire Burks, Chandra Kurien, *Securities Fraud*, 50 AM. CRIM. L. REV. 1479, 1480-81 (2013)

<sup>172</sup> 17 C.F.R. § 240.10b-5 (2011). The 1933 Act also contains a general fraud provision under § 17(a), which can also be utilized in criminal prosecutions. *See* 15 U.S.C. § 77q(a) (2006). The language of § 17(a) of the 1933 Act has been incorporated into Rule 10b-5, creating similar obligations under the two provisions. *See SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999) (“Essentially the same elements are required under section 17(a)(1) - (3) [as under Rule 10b-5] ... though no showing of scienter is required ... under subsections (a)(2) or (a)(3).” (*SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996))). *But see Finkel v. Stratton Corp.*, 962 F.2d 169, 175 (2d Cir. 1992) (holding that although Rule 10b-5 allows for a private right of action does not mean the same can be provided under § 17(a)).

<sup>173</sup> 15 U.S.C. § 78ff(a) (2006).

<sup>174</sup> 15 U.S.C. § 78j(b) (authorizing the SEC to implement rules “necessary or appropriate in the public interest or for the protection of investors”).

<sup>175</sup> 15 U.S.C. § 78ff(a).

<sup>176</sup> *See id.* at 543-545 (explaining that private plaintiffs may bring lawsuits only under Rule 10b-5 and may only seek damages, SEC may bring both administrative actions or lawsuits under Rule 10b-5 and § 17 of 1933 Act, the Department of Justice may bring criminal actions when the conduct was willful).

<sup>177</sup> *See* Samuel W. Buell, *What Is Securities Fraud?* 61 DUKE L.J. 511, 545 (2011) (discussing that securities fraud is one of the most judicial created fields of federal law).

misrepresentations, omissions or both, and the second is insider trading.<sup>178</sup> To succeed in a civil case under Rule 10b-5, a plaintiff must show that the defendant made (i) a misstatement or omission<sup>179</sup> (ii) of material fact<sup>180</sup> (iii) with scienter<sup>181</sup> (iv) in connection with the purchase or the sale of a security,<sup>182</sup> (v) upon which the plaintiff reasonably relied,<sup>183</sup> and (vi) that the plaintiff's reliance proximately caused his or her injury.<sup>184</sup> If the elements of Rule 10b-5 are shown to exist, the government may pursue criminal liability under the 1934 Act if they are able to demonstrate that the act was wilful.<sup>185</sup>

Although participation in insider dealing can be found as a securities fraud under Rule 10b-5, it is often difficult to fit it under the crime of fraud.<sup>186</sup> However, regulation of insider dealing under Rule 10b-5 has been found to help protect the marketplace by prohibiting material, non-public information from being used to purchase or sell any security in breach of a fiduciary duty.<sup>187</sup> The following section will discuss insider dealing and discuss the development of the law as a securities fraud.

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<sup>178</sup> Poulos et al., *supra* note 171, at 1481.

<sup>179</sup> See *Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (defining misrepresentations or omissions as assertions that are “are false or misleading or are so incomplete as to mislead”), *Dirks v. SEC*, 463 U.S. 646, 654-55 (1983) (finding that those with a fiduciary duty to investors will be held liable under Rule 10b-5 only when they fail to disclose or fail to abstain from using material nonpublic information); see also *Chiarella v. United States*, 445 U.S. 222, 231 (1980) (limiting the duty to disclose or abstain to corporate insiders).

<sup>180</sup> 17 C.F.R. § 240.10b-5 (prohibiting “any untrue statement of a material fact” or any omission of a “material fact necessary in order to make the statements made ... not misleading”); see *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (finding that a fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in their decision making).

<sup>181</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12, 193-94 (1976) (holding that it must be shown “that the defendant acted with scienter, a mental state embracing intent to deceive, manipulate, or defraud”).

<sup>182</sup> 17 C.F.R. § 240.10b-5; see *United States v. O'Hagan*, 521 U.S. 642, 656 (1997) (requiring that the conduct of disclosing or abstaining be in connection to a securities transaction).

<sup>183</sup> 17 C.F.R. § 240.10b-5; see *Basic Inc. v. Levinson*, 485 U.S. 224, 243(1988) (noting that reliance has always been found to be an element of common law fraud).

<sup>184</sup> See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 342 (2005). This last element may be separated into two separate requirements: (1) economic loss; and (2) loss causation – “a causal connection between the material misrepresentation and the loss.”

<sup>185</sup> See *United States v. Cassese*, 428 F.3d 92, 98 (2d Cir. 2005) (defining willfulness as “a realization on the defendant's part that he was doing a wrongful act” under the securities laws”).

<sup>186</sup> See Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 *Hastings L.J.* 881, 889 (2010) (“[D]ealing with insider trading through an antifraud rule is like trying to fit a square peg into a round hole.”).

<sup>187</sup> 15 U.S.C. § 78b (declaring one of the purposes of Rule 10b-5 is “to insure the maintenance of fair and honest markets”).

## Insider Dealing

The United States is home to two of the largest stock exchanges in the world.<sup>188</sup> Given the high concentration of securities being traded in the U.S., regulation of insider dealing is critical.<sup>189</sup> The penalties if convicted of insider dealing are a maximum of twenty years in prison and a fine of \$5 million.<sup>190</sup> There is also the possibility of civil penalties, which can equate to fines up to three times the profit gained or loss avoided as a result of the insider dealing.<sup>191</sup> Insider dealing has become a “catchphrase used to describe a particular type of securities fraud – that which involves trading on material information that is unavailable to the marketplace.”<sup>192</sup> This type of trading qualifies as a “deceptive device” under § 10(b)<sup>193</sup> and Rule 10b-5.<sup>194</sup> However, no statute has ever attempted to create a real definition for the practice of insider dealing.<sup>195</sup> Congress and the Securities Exchange Commission have not been able to agree on a definition of insider dealing because of fear that inside dealers may be able to evade a specific concrete definition.<sup>196</sup> Accordingly, the courts have been left to define the term through the use of common law.<sup>197</sup>

Although the law of insider dealing is a complex field, the United States has long believed in strong enforcement in order to encourage development of the U.S. capital markets by facilitating investment in its stock markets.<sup>198</sup> The U.S. Supreme Court has also

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<sup>188</sup> James Thompson, A Global Comparison of Insider Trading Regulations, *Int'l J. Acct. & Fin.* 1, 4 (2013) (listing the New York Stock Exchange and NASDAQ as two of the largest exchanges based on market capitalization).

<sup>189</sup> *Ibid.*

<sup>190</sup> *Ibid.*

<sup>191</sup> *Ibid.*

<sup>192</sup> Robert G. Morvillo & Robert J. Anello, *The Evolving Mystery of Illegal Insider Trading*, N.Y. L.J., Aug. 3, 2010, available at [http://www.maglaw.com/publications/articles/00225/\\_res/id=Attachments/index=0/070081001Morvillo.pdf](http://www.maglaw.com/publications/articles/00225/_res/id=Attachments/index=0/070081001Morvillo.pdf)

<sup>193</sup> 15 U.S.C. § 78j(b).

<sup>194</sup> 17 C.F.R. § 240.10b-5.

<sup>195</sup> *Ibid.*

<sup>196</sup> Richard A. Booth, *The Missing Link Between Insider Trading and Securities Fraud*, 2 *J. Bus. Tech. L.* 185,196 (2007)

<sup>197</sup> Ted Kamman & Rory T. Hood, *With the Spotlight on the Financial Crisis, Regulatory Loopholes, and Hedge Funds, How Should Hedge Funds Comply with the Insider Trading Laws?* 2009 *Colum. Bus. L. Rev.* 357, 363-64 (2009) (describing the development of insider trading common law where legal rules are created on a case-by-case manner with respect to specific fact patterns).

<sup>198</sup> Arthur Levitt, Chairman, SEC, *A Question of Investor Integrity: Promoting Investor Confidence by Fighting Insider Trading*, Address Before the “SEC Speaks” Conference (Feb. 27, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch202.txt> (“Our markets are a success precisely because

long held that the principal purpose of the federal securities law is to fix the insufficiencies of common law protections to ensure the fair and honest functioning of the stock market.<sup>199</sup> Accordingly, the legal development of the law has become essential to understanding the prohibition of insider dealing. The law beginning the prohibition of insider dealing began in the SEC's 1961 case, *In re Cady, Roberts & Co.*<sup>200</sup>. This case involved a broker who received information from a company's director that the company was deciding to reduce the amount of dividends to be issued.<sup>201</sup> Using the information from the director, the broker decided to sell shares in the company to several of his clients prior to the news going public.<sup>202</sup> The SEC brought suit under Rule 10b-5 to establish the broker's liability for trading on inside information.<sup>203</sup> The SEC found the duty that corporate insiders have not to use inside information for personal gain could attach to other individuals outside of the corporation as well.<sup>204</sup> Therefore, the SEC held that the duty to abstain from trading on insider information that is not public rests on two factors, first, because there exists a relationship that allows access to information which is intended for corporate use and not personal benefit, and second, because there is an inherent unfairness when a party takes advantage of such information knowing it is not available to everyone.<sup>205</sup> Thus, the rule for "disclose or abstain" was developed. The rule created what are known as "temporary" or "constructive" insiders, who share the duty to disclose all material non-public information known to them prior to trading, or abstain from trading until the information becomes public.<sup>206</sup>

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they enjoy the world's highest level of confidence. Investors put their capital to work-and put their fortunes at risk-because they trust that the marketplace is honest").

<sup>199</sup> See, e.g., *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 170-71 (1994) (finding that the Securities Act of 1933 and the Securities Exchange Act of 1934 "embrace a fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of caveat emptor"). Caveat emptor is a Latin term meaning "let the buyer beware."

<sup>200</sup> *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

<sup>201</sup> *Ibid.*

<sup>202</sup> *Ibid.*

<sup>203</sup> *Ibid.*

<sup>204</sup> *Ibid.*

<sup>205</sup> *Ibid.*

<sup>206</sup> Diana L. Hegarty, *Rule 10b-5 and the Evolution of Common-Law Fraud - The Need for an Effective Statutory Proscription of Insider Trading by Outsiders*, 22 *SUFFOLK U. L. REV.* 813, 820-21 (1988).

The “disclose or abstain” rule was expanded on several years later in *SEC v. Texas Gulf Sulphur Co.*<sup>207</sup> In *Cady*, the rule applied only to those who received information from a corporate insider, however, in *Texas Gulf Sulphur*, the rule was extended to any person who knew of material, non-public information.<sup>208</sup> The Second Circuit held that “anyone in possession of material inside information must either disclose it to the investing public, or must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.”<sup>209</sup> The court felt that there should be “equal access” to information in order to ensure fairness in the markets.<sup>210</sup> The court found “[i]t was the intent of Congress that all members of the investing public should be subject to identical market risks.”<sup>211</sup>

### 1. Classical Insider Dealing

Over a decade later, the Supreme Court faced its first insider dealing case, *Chiarella v. United States*,<sup>212</sup> in which it rejected the notion that anyone in possession of material, non-public information could be held liable for insider dealing.<sup>213</sup> In *Chiarella*, the defendant worked at a financial printing firm.<sup>214</sup> While working on certain documents, he discovered the identities of two companies that were about to undergo a tender offer and used this information to buy shares prior to the information going public, making a profit as the share prices went up.<sup>215</sup> The Supreme Court found that although § 10(b) is a “catchall” provision, any conviction under it must be based on fraud.<sup>216</sup> The Court held that in order for the defendant to have acted fraudulently, he must have had a duty disclose or abstain.<sup>217</sup> Given that Chiarella did not receive the information from a corporate insider, it could not be found that his possession of the information rose to an existence of a

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<sup>207</sup> *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

<sup>208</sup> *Ibid.*

<sup>209</sup> *Ibid.*

<sup>210</sup> *Ibid.*

<sup>211</sup> *Ibid.*

<sup>212</sup> *Chiarella v. United States*, 445 U.S. 222 (1980).

<sup>213</sup> *Ibid.*

<sup>214</sup> *Ibid.*

<sup>215</sup> *Ibid.*

<sup>216</sup> *Ibid.*

<sup>217</sup> *Ibid.*

fiduciary duty that would create such a duty to disclose or abstain.<sup>218</sup> Soon after the Court handed its decision, the SEC implemented Rule 14e-3, in order to address situations involving tender offers and imposed a duty to “disclose or abstain,” regardless of the existence of any fiduciary duty.<sup>219</sup>

Three years after *Chiarella*, the Supreme Court had another opportunity to develop the insider dealing laws with *Dirks v. SEC*, a “tippee” case.<sup>220</sup> Dirks, a securities analyst, received inside information regarding a massive company fraud.<sup>221</sup> Both the *Wall Street Journal* and the SEC had been informed about the fraud, yet no response or action had been taken.<sup>222</sup> Dirks then informed his clients who then sold their shares in the company, leading to an investigation and public disclosure of the company’s fraudulent activities.<sup>223</sup> The SEC brought sanctions against Dirks for using the information, but the Supreme Court reversed the decision.<sup>224</sup> The Court held again that any duty to disclose or abstain must be based on the existence of a fiduciary duty.<sup>225</sup> A defendant (the tippee) can only be liable if the insider (tipper) has breached a fiduciary duty.<sup>226</sup> Thus, the Court found that whether there has been a breach of a fiduciary duty depends also in part on the intent of the disclosure, that is, whether it was to benefit the tipper.<sup>227</sup> Dirks tipper was motivated to expose the fraud occurring in the company, there was no personal gain by his disclosure and therefore the tipper did not breach his fiduciary duty.<sup>228</sup> The key factor in the analysis became whether the insider (the tipper) benefited, either directly or indirectly.<sup>229</sup> In its holding, the Court recognized the notion of information as a commodity, which has been interpreted as a property right, but that there still must exist a duty in order to be liable for trading on non-public, material information.<sup>230</sup>

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<sup>218</sup> Ibid.

<sup>219</sup> 17 C.F.R. § 240.14e.

<sup>220</sup> *Dirks v. SEC*, 463 U.S. 646 (1983).

<sup>221</sup> Ibid.

<sup>222</sup> Ibid.

<sup>223</sup> Ibid.

<sup>224</sup> Ibid.

<sup>225</sup> *Dirks v. SEC*, 463 U.S. at 655.

<sup>226</sup> Ibid.

<sup>227</sup> Ibid.

<sup>228</sup> Ibid.

<sup>229</sup> Ibid.

<sup>230</sup> Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges and the*

## Misappropriation Theory of Insider Dealing

The most current wave of insider dealing law began with *United States v. O'Hagan*,<sup>231</sup> where the Court began to shift from a tort-driven theory (found in *Chiarella*) to an agency law and restitution based theory.<sup>232</sup> In *O'Hagan*, the defendant was a partner at a law firm which had been hired by Grand Met to work on its acquisition of Pillsbury Company.<sup>233</sup> Although O'Hagan did not work on the acquisition himself, he came across the details of the plan and decided to purchase Pillsbury shares.<sup>234</sup> Once the acquisition became public, the Pillsbury stock and purchase options increased in price.<sup>235</sup> O'Hagan was able to sell his shares and make a \$4.3 million profit.<sup>236</sup>

O'Hagan was found to have violated Rule 10b-5 based on the "misappropriation theory." The Supreme Court held that the theory applies when a defendant "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."<sup>237</sup> Thus, the Supreme Court found that O'Hagan had a duty of trust and confidence to the law firm since he was a partner there.<sup>238</sup> The Court also found that the fiduciary duties owed to the law firm in turn attached to their client, Grand Met.<sup>239</sup> The Court agreed with the Government's argument that O'Hagan's conduct constituted a fraudulent device in connection with the securities transactions and was therefore liable under § 10(b).<sup>240</sup> The O'Hagan court found that both the classical and misappropriation theories complement each other since both address the effects of capitalizing on non-public information in buying or selling stock.<sup>241</sup> The Court found that while the classical theory focuses on a corporate insider's breach of fiduciary duties owed

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Production of Information, Sup. Ct. Rev. 309 (1981).

<sup>231</sup> *United States v. O'Hagan*, 521 U.S. 642 (1997).

<sup>232</sup> See Robert B. Thompson, *Insider Trading, Investor Harm, and Executive Compensation*, 50 CASE W. RES. L. REV. 291, 296 (1999).

<sup>233</sup> *O'Hagan*, 521 U.S. at 647.

<sup>234</sup> *Ibid.*

<sup>235</sup> *Ibid.*

<sup>236</sup> *Ibid.*

<sup>237</sup> *Ibid.*

<sup>238</sup> *O'Hagan*, 521 U.S. at 653.

<sup>239</sup> *Ibid.*

<sup>240</sup> *Ibid.*

<sup>241</sup> *Ibid.*



to their shareholders, the misappropriation theory addresses the corporate outsiders who breach their duties of trust owed to the source of information.<sup>242</sup> As such, the misappropriation theory is in place in order to safeguard the integrity of the marketplace as a whole from those who attempt to abuse privileged information for their own personal gain.<sup>243</sup>

### **The United Kingdom and Insider Dealing**

The belief that insider dealing leads to a lack of confidence in the stock markets and diminishes the amount of capital invested in the marketplace is no longer only found in the United States.<sup>244</sup> However, it is a recent development that other countries have been taking a more stringent approach to dealing with this issue.<sup>245</sup> The United Kingdom was the first European country to criminalize insider dealing,<sup>246</sup> but it does not have as an extensive of a history as the United States in regulating insider dealing.<sup>247</sup> As home to the fourth largest stock exchange in the world, the U.K. has been pushing for harsher penalties.<sup>248</sup> Nevertheless, over the years the U.K. has developed the most comprehensive legal framework for insider dealing country in the European Union.<sup>249</sup> In Britain for many years it was argued that the best way to deal with insider abuse was through self-regulatory rule such as to be found in the then City Code on Take-overs and Mergers and Stock

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<sup>242</sup> Ibid

<sup>243</sup> Ibid.

<sup>244</sup> Christopher P. Montagano, *The Global Crackdown on Insider Trading: A Silver Lining to the "Great Recession"*, 19 *IND. J. GLOBAL LEGAL STUD.* 575, 577 (2012).

<sup>245</sup> See *id.* at 578 (noting that the recent legal development in insider dealing law in the United Kingdom demonstrates a renewed focus for the European Union).

<sup>246</sup> Udit Grover & Varun Chandra, *Insider Trading: A Modern Day Crime or Not?* (Apr. 28, 2014) available at <http://ssrn.com/abstract=2430039>

<sup>247</sup> See Margaret Cole, Director of Enforcement, FSA London School of Economics, *Insider Dealing in the City*, (Mar. 17, 2007) (transcript available at [http://www.fsa.gov.uk/library/communication/speeches/2007/0317\\_mc.shtml](http://www.fsa.gov.uk/library/communication/speeches/2007/0317_mc.shtml)) (detailing the historical background of insider dealing law in the United Kingdom).

<sup>248</sup> Thompson, *supra* note 188, at 6 (discussing that the current penalties are a maximum prison sentence of seven years or an unlimited fine along with a variety of civil penalties).

<sup>249</sup> Edward Greene & Olivia Schmid, *Duty-Free Insider Trading*, 2013 *COLUM. BUS. L. REV.* 369, 374 (2013). But see Thompson, *supra* note 188, at 7 (noting that the United Kingdom has struggled to obtain convictions for insider dealing).

Exchange's Model Code.<sup>250</sup> Views changed with criminalization of insider abuse in 1980 and full panoply of the criminal justice system was invoked.<sup>251</sup>

The United Kingdom first criminalized insider dealing when Parliament implemented the Companies Act 1980,<sup>252</sup> after the Stock Exchange began arguing for sanctioning the practice.<sup>253</sup> The Companies Act was later consolidated in the Company Securities (Insider Dealing) Act 1985 ("Insider Dealing Act").<sup>254</sup> The Insider Dealing Act prohibited insiders from trading "(1) on the basis of unpublished price-sensitive information, (2) in the securities of the company of which he is an insider, and (3) on a recognized stock exchange."<sup>255</sup> Furthermore, the Act provided a definition of an "insider" which included any person who is or had been an employee, officer, or director, within the previous six months, of a corporation or if the person was professionally associated with the company.<sup>256</sup> The Criminal Justice Act 1993 defined inside information as information that (1) relates to particular securities or their issuers; (2) is specific or precise; (3) has not been made public; and (4) if the information were made public would likely have a significant effect on the price or value of any security.<sup>257</sup> Furthermore, the CJA 1993, s 57 created a distinction between a primary insider - a person who has direct knowledge of inside information - and a secondary insider - a person who learns information from an

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<sup>250</sup> B. Rider "Self-regulation: The British approach to policing conduct in the securities Business, with particular reference to the role of the City Panel on Take-over and Mergers in the regulation of insider trading", *Journal of Comparative Corporate Law and Securities Regulations* (1978) 319, and also B. Rider "the Control of Insider Trading- Smoke Mirrors" *International and Comparative Corporate Law Journal* (1999) 271.

<sup>251</sup> B. Rider "Insider Trading (1983), Jordan and B. Rider and M. Ashe, *Insider Crime* (1993) Jordans and from a comparative prospective B. Rider and H.L. Ffrench, *The Regulation of Insider Trading* (1979) Macmillan.

<sup>252</sup> Companies Act, 1980, c. 22, §§68-73 (U.K.); see also Alexander F. Loke, *From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore*, 54 *AM. J. COMP. L.* 123, 138 (2006) ("It was only in 1980 that insider trading became a crime under U.K. law, through Companies Act 1980 Part V.").

<sup>253</sup> Cole, *supra* note 247.

<sup>254</sup> Company Securities (Insider Dealing) Act, 1985, c. 8, §§1-19 (U.K.).

<sup>255</sup> Ronald E. Bornstein & N. Elaine Dugger, *International Regulation of Insider Trading*, 1987 *COLUM. BUS. L. REV.* 375, 389; see also Company Securities (Insider Dealing) Act §1.

<sup>256</sup> Company Securities (Insider Dealing) Act §§1, 9.

<sup>257</sup> Criminal Justice Act 1993 (CJA), 36, part V, §§ 56, 60(4) (U.K.)

inside source.<sup>258</sup> This terminology was first adapted in Professor Barry Rider, *Insider Dealing* (1983, Jordans).<sup>259</sup>

Additionally, the European Communities (what is now known as the European Union) agreed to promulgate a directive in order to coordinate the regulation of insider dealing.<sup>260</sup> Thus, in 1989, the Economic Community Directive Coordinating Insider Trading (“1989 Directive”) was implemented.<sup>261</sup> The 1989 Directive required member states to prohibit trading that is done in reliance on inside information that is acquired (1) through “membership [in] the administrative, management or supervisory bodies of the issuer,” (2) as a stockholder in the corporation, or (3) due to having access to information “by virtue of the exercise of his employment, profession or duties.”<sup>262</sup> The 1989 Directive was later replaced with the 2003 Market Abuse Directive, which retained the definition of insider dealing.<sup>263</sup>

Prior to the 2003 Directive, the United Kingdom had adopted the Financial Services Market Act of 2000 (“FSMA”), which prohibits market abuse.<sup>264</sup> The FSMA was enforced through the Financial Services Authority (“FSA”).<sup>265</sup> The FSA is a private entity that serves a public function by regulating the marketplace.<sup>266</sup> The FSMA lays out four statutory objectives for the regulatory body: (1) maintain market confidence; (2) contribute to financial stability; (3) secure consumer protection; and (4) reduction of financial crime.<sup>267</sup> Under the FSMA, insider dealing transpires when “an insider deals, or attempts to deal, in a qualifying investment or related investment on the basis of inside information

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<sup>258</sup> Barry AK Rider and HL French. *The regulation of Insider Trading* (1979 Macmillan) and see the discussion of the tippee liability

<sup>259</sup> *Ibid.*

<sup>260</sup> Cole, *supra* note 247.

<sup>261</sup> Council Directive 89/592/EEC, *Coordinating Regulations on Insider Dealing*, 1989 O.J. (L 334) 30.

<sup>262</sup> Council Directive 89/592/EEC, art. II.

<sup>263</sup> Council Directive 2003/6/EC, art. 1. The 2003 Directive also addressed market manipulation.

<sup>264</sup> Slaughter & May, *The EU/UK Market Abuse Regime--Overview 1* (2011) [hereinafter *U.K. Market Abuse Regime*], available at <http://www.slaughterandmay.com/media/39260/the-eu-uk-market-abuse-regime-overview.pdf>; see also FSA, *Who Are We?* [hereinafter *Who Are We?*] <http://www.fsa.gov.uk/Pages/About/Who/index.shtml> (describing the FSA as the primary regulatory body for the financial services).

<sup>265</sup> *U.K. Market Abuse Regime*, *supra* note 264, at 1.

<sup>266</sup> *Who Are We?*, *supra* note 264.

<sup>267</sup> Cole, *supra* note 247.

relating to the investment in question.”<sup>268</sup> FSMA defines insider information as information:

[O]f a precise nature which--(a) is not generally available, (b) relates, directly or indirectly, to one or more issuers of the qualifying investments or to one or more of the qualifying investments, and (c) would, if generally available, be likely to have a significant effect on the price of the qualifying investments or on the price of related investments.<sup>269</sup>

While the United States requires the information to be “material,” the U.K. requires it to be “precise,” when it is found that the information:

(a) indicates circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur, and (b) is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of qualifying investments or related investments.<sup>270</sup>

The definition of “insider” under the FSMA is also defined more broadly than in the United States.<sup>271</sup> Under FSMA, an “insider” is any person who has inside information from (1) being a member of the administration, management, or supervisory bodies of an issuer of qualifying investments; (2) holding the capital of an issuer; (3) having access to the information through the exercise of his or her employment, profession, or duties; (4) engaging in criminal activities; or (5) obtaining the information through other means by which he or she knows, or could reasonably be expected to know, that the information is inside information.<sup>272</sup> In 2012, the U.K. passed the Financial Services Act of 2012, which

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<sup>268</sup> Financial Services and Markets Act (“FSMA”), 2000, c. 8, § 118(2) - (4) (U.K.).

<sup>269</sup> *Ibid.* at § 118C (2).

<sup>270</sup> *Ibid.* at § 118C (5).

<sup>271</sup> Edward Greene & Olivia Schmid, *supra* note 158, at 377.

<sup>272</sup> FSMA, 2000, § 118(B).

actually reorganized its regulatory system.<sup>273</sup> The FSA was replaced with the Financial Conduct Authority, which carries on many of the FSA's duties.<sup>274</sup>

### **Recent Case law in the U.K. and U.S.**

The primary difference between insider dealing laws in the United States and United Kingdom is how it is defined and when liability attaches to an individual.<sup>275</sup> Additionally, the regulatory system of the U.S. is enforcement based while the U.K.'s regulatory framework focuses on supervision and risk based.<sup>276</sup> Recent case law from both the United States and United Kingdom demonstrates the differences of how one regulatory system can find some actions as punishable, while not another.

#### **The Einhorn Case in the United Kingdom and the definition of insider as a critical difference.**

The Financial Services Authority brought a controversial case against Greenlight Capital, Inc., a hedge fund that is located in the United States, and its owner, president and sole portfolio manager, David Einhorn.<sup>277</sup> The FSA concluded that Einhorn had engaged in serious market abuse in breach of section 118(2) of the FSMA.<sup>278</sup> The FSA found that Einhorn was in possession of insider information and caused Greenlight to trade its shares of the UK-listed company, Punch Taverns ("Punch").

Greenlight was a significant U.S. investor in Punch.<sup>279</sup> In June 2009, Punch's corporate broker, Andrew Osborne, approached Greenlight to inquire whether Greenlight

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<sup>273</sup> Richard Powell, UK Regulatory Reform and its Impact on Financial Markets, 19 WORLD SEC. L. REP. (BNA) 34 (May 10, 2013) (describing the replacement of the Financial Services Authority with the new regulatory system of Financial Conduct Authority and the Prudential Regulation Authority (PRA)).

<sup>274</sup> Ibid.

<sup>275</sup> The Einhorn /Greenlight Insider Dealing Case – EU/US Differences Highlighted, Sidley Austin LLP, (Feb. 17, 2012), available at <http://m.sidley.com/the-einhorn-greenlight-insider-dealing-case--euus-differences-highlighted-02-17-2012/> (discussing the differences of insider trading laws between the U.S. and U.K.).

<sup>276</sup> See Cole, supra note 247.

<sup>277</sup> Einhorn, FSA Decision Notice (Jan. 12, 2012) (U.K.) [hereinafter Einhorn Decision], available at <http://www.fsa.gov.uk/static/pubs/decisions/dn-einhorn-greenlight.pdf>.

<sup>278</sup> Ibid.

<sup>279</sup> Ibid.

would agree to be “wall crossed”<sup>280</sup> in order to discuss a potential issuance of equity by Punch.<sup>281</sup> Greenlight declined to be wall crossed because Einhorn did not want to be restricted from trading.<sup>282</sup> Although Punch’s broker tried to persuade Greenlight to be wall crossed, Einhorn continued to disagree and a conference call between Punch management and Greenlight was conducted on an “open” basis instead.<sup>283</sup>

During the conference call, Punch’s management made no statements explicitly referencing an actual transaction, nor did they make a definite statement regarding the size of the anticipated issuance.<sup>284</sup> Punch had made it clear that there had been no definite decisions to proceed with an equity offering and that alternative measures were being taken into consideration.<sup>285</sup> Nevertheless, during the conference call, Einhorn did manage to learn from Punch’s broker, who also participated in the call, that Punch was contemplating an equity offering of about £350 million in order to repay the convertible bond and create headroom in the securitizations.<sup>286</sup> Einhorn also managed to learn that a non-disclosure agreement (wall crossed) would last less than a week.<sup>287</sup> Although Punch stated no definitive decisions had been made, they also discussed that other major shareholders, which indicated the advanced stages and high probability they would be proceeding with the issuance.<sup>288</sup>

Immediately after ending the call, Einhorn instructed Greenlight traders to sell the shareholding in Punch.<sup>289</sup> Commencing shortly after the call, Greenlight traders sold Punch shares over the course of a few days, lowering Greenlight’s holdings of Punch shares from

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<sup>280</sup> Wall crossing is a process whereby a company can legitimately provide inside information to a third party. A common reason is to give the third party inside information about a proposed transaction by a company that is publicly listed. Once a third party agrees to be wall crossed, it can be provided with inside information and it is then restricted from trading.

<sup>281</sup> Einhorn Decision, *supra* 277, at 7.

<sup>282</sup> *Ibid.*

<sup>283</sup> *Ibid.*

<sup>284</sup> *Ibid.*

<sup>285</sup> *Ibid.*

<sup>286</sup> *Ibid.*

<sup>287</sup> Einhorn Decision, *supra* 277, at 8.

<sup>288</sup> *Ibid.*

<sup>289</sup> *Ibid.*

approximately 13.3% to 9%.<sup>290</sup> When Punch made its official announcement of its intention to raise approximately £375 million by means of firm placing and open offer of new ordinary shares, the price of its shares dropped significantly.<sup>291</sup> The decision made by Einhorn to trade Punch shares helped Greenlight avoid a loss of approximately £5.8 million.<sup>292</sup>

The Financial Services Authority concluded that insider information was produced on the conference call and that Einhorn decision to trade was based on that information, in violation of the United Kingdom's market abuse regime.<sup>293</sup> The FSA found that Einhorn fell within the FSMA as an insider given he had access to the information through his employment at Greenlight and his duties as president and portfolio manager of Greenlight.<sup>294</sup> The FSA also found that trading Punch shares was dealing a "qualifying investment" under the statute.<sup>295</sup> Furthermore, it was found that information Einhorn received met the statutory requirements of inside information since it (1) related to Punch and Punch shares, (2) the information was precise,<sup>296</sup> (3) it was not information that was generally available, and (4) the information was likely to have a significant effect on the price of Punch shares.<sup>297</sup>

The FSA explained that due to Einhorn's position and experience, he should have known the information received on the call was confidential and price sensitive that would arise to a legal and regulatory risk.<sup>298</sup> The call should have raised a flag considering it was

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<sup>290</sup> Ibid.

<sup>291</sup> Ibid. at 10 (noting the price of Punch's shares fell by 29.9%).

<sup>292</sup> Ibid.; see also Lindsay Fortado and Ben Moshinsky, Greenlight's David Einhorn Ordered Insider Trades 'Within Minutes' of Tip, Bloomberg (Jan. 25, 2012) available at <http://www.bloomberg.com/news/2012-01-26/greenlight-s-david-einhorn-ordered-insider-trades-within-minutes-of-tip.html> (reporting that the hedge fund avoided a loss of \$9.1 million).

<sup>293</sup> Einhorn Decision, supra 277, at 14.

<sup>294</sup> Ibid. at 10.

<sup>295</sup> Ibid.

<sup>296</sup> Ibid. (finding that the information was precise because: (a) it indicated an event (i.e., the issue of new shares) that may reasonably have been expected to occur and (b) it was specific enough to enable a conclusion to be drawn as to the possible effect of the share issuance on the price of Punch shares).

<sup>297</sup> Ibid. (holding that the information was significant because a reasonable investor would likely have used the information as a basis of his investment decisions).

<sup>298</sup> Ibid.

with management and followed Einhorn's rejection of being wall crossed.<sup>299</sup> The FSA found that Einhorn should have been more cautious in assessing the information he received.<sup>300</sup> Einhorn committed a grave error of judgment in deciding to sell Greenlight's shares in Punch without prior compliance or legal advice, despite the fact that such resources are readily available within Greenlight and Einhorn.<sup>301</sup> In the FSA's eyes, "reasonable investors are expected to interpret comments made to them in an appropriate manner, which may sometimes mean understanding more than the precise words spoken, or interpreting certain comments in light of the context."<sup>302</sup>

Although Einhorn believed he was not in violation of insider dealing laws, the United Kingdom market abuse regime holds its investors to a high standard and the FSA requires diligence from industry members in ensuring they are within legal and regulatory framework.<sup>303</sup> Thus, after fining Einhorn and Greenlight £7.2 million for insider trading,<sup>304</sup> the FSA even decided to sue Andrew Osborne, Punch's broker and imposed a fine for improper disclosure of inside information.<sup>305</sup> Greenlight's U.K. compliance officer also was sued and fined by the FSA, for his failure to make reasonable inquiries that the trade instructions were not based on insider information.<sup>306</sup>

The FSA decision not only to sue Einhorn, but also fine him significantly came as a shock to many in the United States.<sup>307</sup> In the United States, it is unlikely that Einhorn would have come under the same decision in a U.S. court or SEC administrative

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<sup>299</sup> Ibid.

<sup>300</sup> Ibid.

<sup>301</sup> Einhorn Decision, *supra* 277, at 15.

<sup>302</sup> Ibid.

<sup>303</sup> Edward Reed, *The FSA vs. David Einhorn: A Case of Regulatory Overreach?* SEVEN PILLARS INST. available at <http://sevenpillarsinstitute.org/case-studies/the-fsa-vs-david-einhorn-a-case-of-regulatory-overreach> ("The regulator is making a larger statement to the entire finance industry. The first statement notes that there exist laws by which the industry and its members must abide. The second statement emphasizes to and informs practitioners there also are expectations of a standard of ethics that financial professionals must work towards achieving").

<sup>304</sup> *See id.* (discussing the fine equated to \$12.5 million).

<sup>305</sup> Osborne, FSA Final Notice (Feb. 15, 2012) (U.K.), available at [http://www.fsa.gov.uk/pubs/final/andrew\\_osborne.pdf](http://www.fsa.gov.uk/pubs/final/andrew_osborne.pdf).

<sup>306</sup> Osborne, FSA Final Notice (Feb. 15, 2012) (U.K.), available at [http://www.fsa.gov.uk/pubs/final/andrew\\_osborne.pdf](http://www.fsa.gov.uk/pubs/final/andrew_osborne.pdf).

<sup>307</sup> Greene and Schmid, *supra* note 158, at 382.



proceeding.<sup>308</sup> Although the Einhorn case can resemble insider trading scenario, it lacks important details for it to be brought on charges in the United States. Despite Einhorn's argument that the information received on the call could not be insider information because he refused to sign a non-disclosure agreement.<sup>309</sup>

In analysing the classical theory<sup>310</sup> or misappropriation theory<sup>311</sup> of insider dealing in the U.S., the Einhorn case lacks the necessary duty to be found in violation of Rule 10b-5 or Section 10.<sup>312</sup> Neither Greenlight nor Einhorn owed a fiduciary duty to Punch or its shareholders.<sup>313</sup> They also did not fulfil any role or position that would require a fiduciary duty to the sources of the information.<sup>314</sup> In deciding to not sign a confidentiality agreement in order to be wall crossed, Einhorn made clear he did not want to be an insider or restrict his trading. Thus, there would be no duty owed and no violation of insider dealing laws within the United States.<sup>315</sup> Additionally, as the *SEC v. Cuban* case would illustrate, establishing a duty is not as simple as signing a confidentiality agreement.<sup>316</sup>

In contrast, the United Kingdom's definition of insider trading is much broader, as can be evidenced from the Einhorn case. The theory is based on possession of the

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<sup>308</sup> Peter J. Henning, Einhorn Case Highlights Britain's Broader Definition of Insider Trading, WALL ST. J., Jan. 31, 2012 available at <http://dealbook.nytimes.com/2012/01/31/einhorn-case-highlights-britains-broader-definition-of-insider-trading>.

<sup>309</sup> Seeid. (discussing U.S. test to determine inside information is whether a reasonable investor would consider it important and if the company took measures to remain confidential); see also Selective Disclosure and Insider Trading, Securities Act Release No. 7881, 73 SEC Docket 3 (Aug. 15, 2000) (listing various examples of material information such as specific earnings, proposed nonpublic mergers, acquisitions, etc.).

<sup>310</sup> See discussion supra II.B.1.

<sup>311</sup> See discussion supra II.B.2.

<sup>312</sup> See Greene and Schmid, supra note 158, at 386.

<sup>313</sup> See generally, Chiarella v. United States, 445 U.S. 222 (1980) (limiting the duty to disclose or abstain to corporate insiders who owe a fiduciary duty). But see Noam Noked, Differenced Between US and UK Market Abuse Regimes, HARV. L. SCH. F. ON CORP GOV. & FIN. REG., Apr. 7, 2012, available at <http://blogs.law.harvard.edu/corpgov/2012/04/07/differences-between-us-and-uk-market-abuse-regimes> (noting that a fiduciary duty can be found to exist based on controlling shareholder status).

<sup>314</sup> See generally, United States v. O'Hagan, 521 U.S. 642 (1997) (holding the need for a duty of trust and confidence to source of the information).

<sup>315</sup> Brooke Masters & Dan McCrum, Gulf Between US and UK 'Insider Trading', FIN. TIMES, Jan. 26, 2012, available at <http://www.ft.com/intl/cms/s/0/d2f943ae-4811-11e1-a4e5-00144feabdc0.html#axzz2AAET8CgL>.

<sup>316</sup> SEC v. Cuban, 634 F. Supp. 2d 713, 718-19 (N.D. Tex. 2009) (holding that that a confidentiality agreement alone was insufficient to establish a breached fiduciary duty and that an additional agreement to abstain from trading on the confidential information would be required).

information and dealing on a basis of it. The U.S. Supreme Court had rejected the possession theory when it overruled the Second Circuits decision in *SEC v. Texas Gulf Sulphur Co.*<sup>317</sup> in *Chiarella*. Accordingly, the possession theory in use in the U.K. leads to more possibilities of insider dealing cases that could lead to more convictions. Although the U.S. has tried to add to their insider trading laws to create additional scenarios that establish a duty of trust or confidentiality, it has not been completely successful.

### **Martoma in the United States and attachment of liability as a critical difference.**

In February 2014, Mathew Martoma, a former portfolio manager at SAC Capital Advisors hedge fund, was found guilty in what U.S. prosecutors have called the most lucrative insider trading case in the history of the United States.<sup>318</sup> The insider trading scheme Martoma was involved in allowed SAC Capital to make profits and avoid losses of about \$275 million.<sup>319</sup> Martoma became the eighth former SAC employee charged for insider trading.<sup>320</sup> Martoma, who worked in SAC's CR Intrinsic Investors division and was responsible for investment decisions in public companies in the health care sector, including Elan Corp. and Wyeth Ltd., which are pharmaceutical companies.<sup>321</sup> Both Elan and Wyeth were involved in the development of experimental drugs for Alzheimer's disease.<sup>322</sup> The results of a clinical trial drug that was being conducted by Elan and Wyeth, which offered a novel but untested approach to treating Alzheimer's, were soon to be released, and scientists and investors were eager to hear about the results.<sup>323</sup>

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<sup>317</sup> See. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (holding that "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.")

<sup>318</sup> *United States v. Martoma*, No. 12-CR-00973, verdict returned (S.D.N.Y. Feb. 6, 2014).

<sup>319</sup> Nate Raymond, SAC Capital's Martoma Found Guilty of Insider Trading, REUTERS, Feb. 6, 2014 available at <http://www.reuters.com/article/2014/02/06/us-sac-martoma-idUSBREA131TL20140206>.

<sup>320</sup> *Ibid.*

<sup>321</sup> *Acquisitions and Mergers: Negotiated and Contested Transactions*, 11 *Acquisition & Mergers* § 1:29.30 [hereinafter *Acquisitions and Mergers*].

<sup>322</sup> *Ibid.*

<sup>323</sup> *Ibid.*

Martoma, who began working for SAC Capital in 2006, began using expert networking firms<sup>324</sup> in order to try and discuss the drug trials with doctors who were involved and who had access to confidential information.<sup>325</sup> In his efforts to do this, Martoma managed to arrange various paid consultations with one of the drug trial's principal investigators, Dr Joel Ross, along with the Chairman of the drug trial's Safety Monitoring Committee ("SMC"), Dr Sidney Gilman.<sup>326</sup> Martoma took advantage of his personal and financial relationships with the doctors in order to obtain insider information regarding the drug trial.<sup>327</sup> Martoma received reports on patients under Dr Ross's care as well as generally positive safety data about the drug trial.<sup>328</sup> In fact, after every SMC meeting for the trial drug, Martoma would arrange for a paid consultation with Dr Gilman in order to be one of the first to hear about any substantive safety issues the drug was having, such information could lead to Martoma learning the drug would be cancelled and therefore, decrease in Wyeth and Elan stock prices.<sup>329</sup> Given that the information he had been receiving was generally positive, Martoma purchased and held shares in Elan and Wyeth and also recommended the owner of SAC capital, Steve Cohen, to do the same.<sup>330</sup> By spring of 2008, SAC Capital held approximately \$700 million worth of Elan and Wyeth shares.<sup>331</sup>

In July 2008, in preparation for the release of the drug trial's full results, Dr. Gilman received a power point that he was to present at the International Conference on Alzheimer Disease ("ICAD Presentation"). The presentation was marked as "Confidential, Do not Distribute." The power point revealed that the trial results were negative and raised serious questions about how well the drug would do in the marketplace.<sup>332</sup> Martoma found the information out after calling Dr Gilman and even flew to meet him to review the power

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<sup>324</sup> Bradley J. Bondi & Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defences, and Best Practices for Ensuring Compliance*, 8 N.Y.U. J. L. & Bus. 151, 177 (2011) (noting that the term "expert network" refers to firms that are in the business of connecting clients, principally institutional investors, with persons who may be experts in the client's area of interest).

<sup>325</sup> *Acquisitions and Mergers*, supra note 321.

<sup>326</sup> *Ibid.*

<sup>327</sup> *Ibid.*

<sup>328</sup> *Ibid.*

<sup>329</sup> *Ibid.*

<sup>330</sup> *Ibid.*

<sup>331</sup> *Acquisitions and Mergers*, supra note 321.

<sup>332</sup> *Ibid.*

point himself.<sup>333</sup> After reviewing the power point, Martoma had a twenty minute phone call with Steven Cohen. Cohen soon instructed SAC traders to sell all Elan and Wyeth shares prior to the ICAD presentation. In the course of one week, SAC sold all of its shares in Elan and Wyeth, a total of 17.7 million worth \$700 million.<sup>334</sup> After the ICAD presentation, Elan stock closed 42% lower and Wyeth's dropped approximately 11%. Although Martoma has not been sentenced yet, he is expected to receive record jail time as the court's probation department had recommended a 20 year sentence.<sup>335</sup>

This case highlights the complexity of insider trading. Expert networks, described as "Wall Street matchmakers who connect large investors with outside experts," have grown to capture the SEC's attention for potential insider trading cases.<sup>336</sup> While a quick glance at the facts may not show how liability attaches to Martoma and not Einhorn, the reason is in the details. Expert networks are not per se illegal or improper.<sup>337</sup> However, it has often become the case of misusing or actively trying to gain the edge with seeking out nonpublic material information in order to trade, as is the case with Martoma. The case can fall under the tipper/tippee line of cases that attach liability when an insider provides material nonpublic information to an outsider without sufficient justification to do so, and the outsider-tippee buys or sells securities based on the information received.<sup>338</sup>

In order for liability to attach in a tippee case, there are three elements needed for Dirks to apply in the Martoma's case. First, that the outsider-tippee received material non-

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<sup>333</sup> Ibid.

<sup>334</sup> Ibid.

<sup>335</sup> Mathew Goldstein, Former Trader at SAC Capital Seeks a Lenient Sentence, NEW YORK TIMES, May 28, 2014 (discussing that Raj Rajaratnam has received the harshest sentence of 11 years for insider trading and Martoma should be sentenced in June 2014).

<sup>336</sup> Evelyn M. Rusli, Next Up, A Crackdown on Outside-Expert Firms, N.Y. TIMES, May 11, 2011, available at <http://dealbook.nytimes.com/2011/05/11/next-up-a-crackdown-on-outside-expert-firms> (discussing how federal prosecutors are focusing on the use of expert networks).

<sup>337</sup> See Azham Ahmed & Peter Lattman, Insider Inquiry Pivots Its Focus To Hedge Funds, N.Y. Times, Feb. 9, 2011 available at <http://query.nytimes.com/gst/fullpage.html?res=9C02E5D81030F93AA35751C0A9679D8B63&pagewanted=all> (quoting Preet Bharara, U.S. Attorney for the Southern District of New York, "while there was nothing inherently wrong with hedge funds or expert network firms, if you have galloped over the line; if you have repeatedly made a mockery of market rules; if you have converted a legitimate enterprise into an illegal racket, then you have done something wrong and you will not get a pass") (internal quotation marks omitted).

<sup>338</sup> Dirks v. SEC, 463 U.S. 646, 651 (1983).

public information from an insider-tipper who knowingly breached their fiduciary duties of trust and confidence to the source of the information.<sup>339</sup> Second, the tippee must know or should have known that the insider was breaching their fiduciary duties by disclosing the information.<sup>340</sup> Third, the tippee must use the information in a securities transaction.<sup>341</sup> As discussed above, the intent of the tipper does weigh in as a factor. However, the court has diminished the requirement of a personal benefit for the tipper.<sup>342</sup> In *Martoma's* case, each element is present to be held liable. First, *Martoma*, as the outsider-tippee, received a tip from an insider-tipper, Dr. Gilman and Dr. Ross, both who knowingly breached their fiduciary duties of trust and confidence to *Elan* and *Wyeth*.<sup>343</sup> Second, *Martoma* actively sought the information, often exploiting the relationship to gain the information regarding the classified drug trial.<sup>344</sup> Lastly, *Martoma* clearly engaged in security transactions based on the non-public material information he obtained from the insiders.<sup>345</sup>

The difference that the tipper-tippee cases present is the analysis needed to attach liability. *Dirks* established the derivative nature of liability when it comes to tippees in the United States. As discussed above, without a showing of a personal benefit for the tipper, the courts would not be able to find the tippee liable.<sup>346</sup> Now, the courts are attempting to dilute this requirement. In the *Obus* case, the court determined that the term “personal benefit” has a broad definition and that it is not a high threshold to meet.<sup>347</sup> A finding that the tipper and tippee were friends in that case was deemed sufficient to question whether there was a personal benefit involved in act of disclosing information.<sup>348</sup> This is a critical movement in the law governing insider trading considering that previously, a tippee would only be liable for trading on the material non-public information if the tipper disclosed for

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<sup>339</sup> *Dirks*, 463 U.S. at 662-64.

<sup>340</sup> *Ibid.* at 651.

<sup>341</sup> *Ibid.* at 659.

<sup>342</sup> *SEC v. Obus*, 693 F.3d 276, 291 (2d Cir. 2012) (finding the standard to be satisfied because the tipper and tippee were college friends).

<sup>343</sup> Kevin McCoy, *Martoma Prosecution Witness Bends, Doesn't Break*, USA TODAY, Jan. 24, 2014, available at <http://www.usatoday.com/story/money/business/2014/01/24/sidney-gilman-testimony-martoma-trial/4836009>.

<sup>344</sup> *Ibid.*

<sup>345</sup> *Ibid.*

<sup>346</sup> *Dirks*, 463 U.S. at 661.

<sup>347</sup> *SEC v. Obus*, 693 F.3d 276, 292 (2d Cir. 2012).

<sup>348</sup> *Ibid.* at 291.

a personal benefit.<sup>349</sup> Thus, an inadvertent disclosure or genuine mistake on the part of the tipper could have saved the tippee from facing liability.<sup>350</sup>

Although the courts are now trying to rework the standard in the U.S., the United Kingdom has a very different approach to such cases. In the U.K., the liability is irrespective of the tipper's conduct or liability.<sup>351</sup> When there is sufficient evidence to demonstrate that the tippee knew or should have known they were receiving insider information, liability will attach.<sup>352</sup> Thus, each party is liable for their own culpable behavior, regardless of the liability the other would have.<sup>353</sup> In order to determine liability and ensure innocent parties are not brought under the statute, there is a scienter requirement.<sup>354</sup> While neither has a perfect outcome, the United Kingdom again allows for greater reach and prosecution of insider dealing cases. While the United Kingdom requires deliberate intent under criminal insider dealing, a civil case can be successful under market abuse simply due to inadvertent or unintentional violations.<sup>355</sup> This is allowed because FSMA does not require an individual to act deliberately or recklessly.<sup>356</sup> Thus, under U.K. law, a person does not have to be aware that they are committing an unlawful act or intentionally commit an illegal trade. A totality of circumstances will be examined to determine whether insider dealing has occurred or not, which bring more defendants under the regime.<sup>357</sup>

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<sup>349</sup> Edward Greene & Olivia Schmid, *supra* note 158, at 394.

<sup>350</sup> Joan MacLeod Heminway, *Willful Blindness, Plausible Deniability and Tippee Liability: Sacs, Steven Cohen, and the Court's Opinion in Dirks*, 15 *TRANSACTIONS: TENN. J. BUS. L.* 47, 56 (2013) (conveying the fact that U.S. law potentially can allow individuals to structure securities trading in a way that protects them from individual, personal liability).

<sup>351</sup> See Financial Services and Markets Act, 2000, c. 8, § 118B (U.K.).

<sup>352</sup> *Ibid.*

<sup>353</sup> Edward Greene & Olivia Schmid, *supra* note 158, at 395.

<sup>354</sup> *Insiders: Factors to Be Taken into Account*, 2000, MAR 1.2.8E (U.K.), available at <http://fsahandbook.info/FSA/html/handbook/MAR/1/2/#D46> (discussing the test as whether a reasonable person in the individual's position should have known the information obtained was privileged).

<sup>355</sup> Masters & McCrum, *supra* note 315.

<sup>356</sup> *Noked*, *supra* note 313.

<sup>357</sup> Kylie Franklin, *U.S. v. U.K. Insider Trading Laws: Who Is the Top Dog?* (Feb. 21, 2013) available at SSRN: <http://ssrn.com/abstract=2308356> or <http://dx.doi.org/10.2139/ssrn.2308356>.

## Strengths and Weaknesses of Insider Dealing Regimes in U.S. and U.K.

In the United States, Rule 10b-5 has been linked to the need for an efficient marketplace,<sup>358</sup> with the goal of the antifraud regime being to “improve the efficiency of the market so that the price reflects value, and therefore, financial, and ultimately real, resources will be optimally allocated.”<sup>359</sup> Permitting fraud would increase investors’ risks and thus cause a lack of confidence. Although some scholars argue that insider dealing should be legalized,<sup>360</sup> many others argue that Rule 10b-5 exist in order to protect investors.<sup>361</sup> There has even been evidence that suggests the securities laws in the U.S. have greatly benefited investors.<sup>362</sup>

Fraud is an extremely broad concept,<sup>363</sup> in which the courts, legislatures, and agencies have grappled to fit insider dealing, a narrower concept into it. The problem with the United States fitting insider dealing into a fraud scheme has been that it becomes more difficult to determine in what scenarios nondisclosure is deceptive.<sup>364</sup> While it is not a farfetched idea to contain insider dealing as a type of fraud, it can become problematic also in that the determination of whether a type of conduct is deceptive changes overtime to meet the expectations of market participants have regarding certain transactions.<sup>365</sup> This can be noted throughout the judicial interpretations of what it means to breach a fiduciary

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<sup>358</sup> William K.S. Wang, Some Arguments that the Stock Market Is Not Efficient, 19 U.C. DAVIS L. REV. 341, 344–49 (1986) (defining fundamental market efficiency when “prices are based on the rational expectations of future payments to which the asset gives title”).

<sup>359</sup> *Ibid.*

<sup>360</sup> Henry G. Manne, Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark, 31 J. Corp. L. 167, 174 (2005) (claiming that no corporate actors have advocated for insider trading regulations); See Thomas A. Lambert, Overvalued Equity and the Case for an Asymmetric Insider Trading Regime, 41 Wake Forest L. Rev. 1045, 1083-95 (2006) (proposing an asymmetric change to insider trading laws to permit “price-decreasing” insider trading but not “price-enhancing” insider trading).

<sup>361</sup> James J. Park, Rule 10b-5 and the Rise of the Unjust Enrichment Principle, 60 DUKE L.J. 345, 351–360 (2010); Gregg A. Jarrell, The Economic Effects of Federal Regulation of the Market for New Security Issues, 24 J.L. & ECON. 613, 635 (1981).

<sup>362</sup> Park, *supra* note 361, at 636.

<sup>363</sup> *Stonemets v. Head*, 154 S.W. 108, 114 (Mo. 1913) (“Fraud is kaleidoscopic, infinite. Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard and fast definition, their jurisdiction would be cunningly circumvented at once by new schemes beyond the definition”).

<sup>364</sup> Samuel W. Buell, What Is Securities Fraud? 61 DUKE L.J. 511, 562 (2011) (explaining that the marketplace also must rely on some acceptable nondisclosures).

<sup>365</sup> *Ibid.*

duty and what actors are held to a certain duty or obligation. In early cases, the U.K. focused more on the classical theory of insider dealing.<sup>366</sup> This meant primarily taking on corporate executives and bankers trading based on their own deals.<sup>367</sup> As time has gone on, the scope of individuals to be included in the securities fraud of insider dealing has expanded greatly.<sup>368</sup>

Additionally, the scope and power behind the insider-dealing regime in the United States is much greater than their U.K. counterparts. The U.S. can manage both criminal and civil cases through two enforcers, the SEC and the Justice Department.<sup>369</sup> Accordingly, even with a narrower definition of the crime of insider dealing than its neighbour across the Atlantic, the United States is able to convict and penalize hundreds of people.<sup>370</sup> The United Kingdom has also sought to protect the integrity of the marketplace as well to ensure market efficiency.<sup>371</sup> Under the Criminal Justice Act of 1993, the offence of insider dealing could only attach liability to individuals, which excluded corporations,<sup>372</sup> despite the fact that the 1989 European Directive required member states to allow liability for both natural and legal persons.<sup>373</sup> This later changed with FSMA which expanded the scope of whom and what was encompassed under the crime of insider dealing.<sup>374</sup> Additionally, prior to FSMA, the CJA only provided for criminal liability for insider dealing which had a high evidentiary threshold.<sup>375</sup> This was problematic for the United Kingdom because the law provided a great opportunity to prosecute, but prosecutions were rare due to the heavy burden to prove beyond a reasonable doubt that the crime in fact occurred.<sup>376</sup> In realizing

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<sup>366</sup> Masters & McCrum, *supra* note 315.

<sup>367</sup> *Ibid.*

<sup>368</sup> *See id.* (examining insider dealing case law which has included reporters, printers, and expert networks).

<sup>369</sup> *Ibid.*

<sup>370</sup> Michelle Celarier, New Notch for Preet as Martoma is Convicted of Insider Trading, *NEW YORK POST*, Feb. 6, 2014 (commenting that the U.S. Attorney has convicted 79 people in five years and has lost no cases); see also Insider Trading Annual Review 2013, Morrison Foerster, available at <http://media.mofo.com/files/Uploads/Images/140108-Insider-Trading-Annual-Review.pdf> (discussing that the SEC filed 43 insider dealing actions in 2013).

<sup>371</sup> Kern Alexander, Insider Dealing and Market Abuse: The Financial Services and Markets Act 2000, *ESRC CENTRE FOR BUS. RES., U. OF CAMBRIDGE* 7–8 (2001), available at <http://www.cbr.cam.ac.uk/pdf/WP222.pdf>.

<sup>372</sup> Criminal Justice Act 1993 (CJA), 36, part V (U.K.)

<sup>373</sup> EC 89/552 (1989).

<sup>374</sup> Alexander, *supra* note 371, at 8.

<sup>375</sup> *Ibid.* at 21.

<sup>376</sup> *Ibid.*



not only the importance of market competitiveness and openness, but also the representation of a clean and fair marketplace, the U.K. incorporated a civil cause of action for market abuse under the FSMA.<sup>377</sup>

Three key differences lie in the U.K. regime which can bring serious consequences to not only corporations, but also investors, who are held to a high standard of due diligence in the U.K. In the U.K. regime, there is no scienter element, breach of duty, or need for securities transaction to be convicted or penalized.<sup>378</sup> Again, leaving many investors open for proceedings or prosecutions in U.K., even if their actions were unintentional.<sup>379</sup> Yet, despite the wider net for insider dealing, the U.K. is not an effective enforcer. Although criminal liability of insider dealing is still difficult and rare to come by, the U.K. is now starting to grow into its enforcement role, bringing more cases each year.<sup>380</sup> The Financial Conduct Authority, although simply replacing the Financial Services Authority, has stepped into a role of more aggressive monitoring and investigation.<sup>381</sup> While doubts have surfaced as to its ability, the FCA and FSA have been coming down on insider dealing more and more.<sup>382</sup> A key difference in the amount of enforcement proceedings or prosecutions is in part due to the fact that the U.K, while a major world market, it is smaller than the U.S.<sup>383</sup> Furthermore, the presence of only one enforcement body has a great impact on the ability to monitor and investigate insider dealing activity.<sup>384</sup> While the U.S. has a stream line federal law with dual enforcers, the U.K. has dual laws and a single enforcer. This leads to limited resources and different laws to apply for criminal and civil actions.<sup>385</sup>

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<sup>377</sup> Ibid.

<sup>378</sup> Michael A. Asaro et al., *Perils Across the Pond: Understanding the Differences Between U.S. and U.K. Insider Trading Regulation*, 5:42 HEDGE FUND L. R. 1, 4 (2012), available at <http://cdn.akingump.com/images/content/1/9/v4/19299/HFLR-Reprint-11-09-12-Insider-Trading-Perils-Across-the-Pond.pdf>.

<sup>379</sup> Ibid.

<sup>380</sup> Masters & McCrum, *supra* note 315.

<sup>381</sup> David Enrich & Harriet Agnew, U.K. Struggles in Fight Against Insider Trading, *WALL S. J. an.* 4, 2014, available at <http://online.wsj.com/news/articles/SB10001424052702303640604579296520563211360>.

<sup>382</sup> Ibid.

<sup>383</sup> Ibid.

<sup>384</sup> Ibid.

<sup>385</sup> Enrich & Agnew, *supra* note 381; see also Abdulsalam Albelooshi, *The Regulation of Insider Dealing: An Applied Comparative Legal Study Towards Reform in UAE*, at 174(2008), available at <https://ore.exeter.ac.uk/repository/bitstream/handle/10036/47094/AlbelooshiA.pdf?sequence=2> (“All things considered, we would conclude that the UK law of insider dealing is fragmented, opaque and repetitive”).

## Conclusion

The obligations that the anti-money laundering laws, anti-insider dealing regulations and increasingly anti-corruption laws impose on those who handle other people's financial transactions to conduct due diligence and operate effective controls to discourage and expose such activity are onerous and well policed.<sup>386</sup> Neither the United States nor the United Kingdom provides perfect examples of insider dealing regulation. The United States is by far the jurisdiction in which insider trading violations are more regularly enforced.<sup>387</sup> The U.S. has become a model for many other countries in developing their laws and enforcement regimes against insider dealing, considering the U.S. has the most prosecutions for the crime.<sup>388</sup> However, the U.S. regime has also been argued to be "inconsistent and erratic . . . regulation that ill serves the investing public."<sup>389</sup> This in turn can seem as though the United States' laws are not sufficient to protect investors and market integrity like other markets.<sup>390</sup> Nevertheless, the crucial factor is enforcement of its laws. While other countries may have wider nets that encompass greater factors for insider dealing, the United States is the country that manages to enforce the most, providing remedies for the breaches. Statutes and insider dealing regimes will only ever be as effective as they can be enforced regularly and bring results.

The United Kingdom, although it has come a long way the past several years, still lacks the ability to enforce its broad regime. As time continues, the U.K. will need to ensure monitoring and investigations are fruitful in order to put its regulations to benefit of its marketplace. The U.K.'s insider dealing regime clearly adopts "equal access" approach to the prohibition of trading on inside information which profound implications for those who trade on U.K. markets. Rather than restrict liability to those who owe a fiduciary duty

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<sup>386</sup> Barry Rider. Dr. Keren Alexander, Lisa Linklater & Stuart Bazley "Market Abuse and Insider Dealing/Second Edition at vii, (2009).

<sup>387</sup> Franklin, *supra* note 357, at 58.

<sup>388</sup> *Ibid.*

<sup>389</sup> Marc I. Steinberg, *Insider Trading – A Comparative Perspective*, IMF 1, 16 (2002), available at <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/steinb.pdf> (observing that while the United States has strong enforcement of their insider trading laws, the laws are still not the most effective and concise application).

<sup>390</sup> *Ibid.*

to the issuer or the source of the information, the FSMA and the CJA impose liability on a broad range of market participants who come to acquire inside information through means that would not restrict them from trading in the United States.<sup>391</sup>

Despite strong regulatory and enforcement powers, the US business judgment rule presumptions generally afford directors and officers protection from personal liability for prudent, informed business decisions made in good faith. As in the UK and other European jurisdiction, directors and officers generally obtain protection from personal liability through indemnification agreements and directors and officers liability insurance in the absent of bad faith or malfeasance, but such protections are limited in certain circumstance by law and regulation.<sup>392</sup> While the control of insider dealing has much in common with the prevention and interdiction of money laundering the next chapter will examine the money laundering.

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<sup>391</sup> The Hedge Fund Law Report, Volume 5, Number 42 (2012)

<sup>392</sup> Ibid

## CHAPTER 3

# MONEY LAUNDERING REGULATION AND COMBATING THE FINANCING OF TERRORISM

### Introduction

The steps taken in recent years against banks by regulators and law enforcement bodies in relation to money laundering have garnered a lot of publicity. The year 2015 saw Barclays fined £72m by the FCA over a £1.9bn deal that ran the risk of being used by launderers and those financing terrorism.<sup>393</sup> In the USA, matters are more extreme. HSBC was fined US\$1.92bn for allowing itself to be used by launderers in Mexico and terrorist financiers in the Middle East.<sup>394</sup> Which causes major threats to financial stability.

Financing is critical for terror organizations to operate.<sup>395</sup> As long as terrorists have access to streams of money, their violent acts will continue.<sup>396</sup> Since September 11, 2001 (“9/11”), reports have been issued stating that al-Qaeda requires an estimated \$30-50 million per year to operate, which is generated from a network of charities, nongovernmental organizations, mosques, websites, intermediaries, facilitators, and banks and other financial institutions.<sup>397</sup>

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<sup>393</sup> Andrew Haynes, (2016) “Editorial”, *Journal of Money Laundering Control*, Vol. 19 Iss; 4, pp. 314 - 315

<sup>394</sup> *Ibid*

<sup>395</sup> In a 2007 interview, former al-Qaeda Chief Treasurer Sheik Saeed declared that “funding is the mainstay of jihad.” Ari Shapiro, *Morning Edition: Obama Stays the Course on Terrorist Financing*, National Public Radio (Mar. 11, 2009), available at <http://www.npr.org/templates/story/story.php?storyId=101676777>.

<sup>396</sup> Amos N. Guiora & Brian J. Field, *Using and Abusing the Financial Markets: Money Laundering as the Achilles' Heel of Terrorism*, 29 *U. PA. J. INT'L L.* 59, 60 (2007) (“[I]t is necessary to recognize the fact that finances are the engine of the terrorist train”).

<sup>397</sup> Jimmy Gurulé, *Unfunding Terror: The Legal Response to the Financing of Global Terrorism* 3 (2008); Nat'l Comm'n on Terrorist Attacks upon the U.S., *THE 9/11 COMMISSION REPORT* 169-72 (2004) [hereinafter *9/11 COMMISSION REPORT*], available at <http://www.9-11commission.gov/report/911Report.pdf>; see also Nick Ridley, *TERRORIST FINANCING: THE FAILURE OF COUNTER MEASURES* 1-2 (2012) (“[E]fforts against terrorist financing tend to be focused on assessing and calculating individual operational costs, and the significance of auxiliary support or infrastructure is not yet fully apparent to organizations and agencies engaged in counter terrorism”).

Accordingly, the global “war” on money laundering has intensified since the attacks of 9/11, and this has included combating terrorist financing as well.<sup>398</sup> The war on terror is not a cheap battle for countries either. Various analysts have estimated that fighting the War on Terror has cost the United States more than \$3 trillion.<sup>399</sup> Similarly, it has been estimated that the United Kingdom spends an estimated £3.5 billion per year to fight terrorism.<sup>400</sup> However, although the United States has spent large amounts of money to fight terrorism with its military, there are many analysts who are concerned that it has not invested sufficient resources in fighting the real lifeline of terrorism: its clandestine network of global financing.<sup>401</sup>

In addition to military action on the ground, countries must also work to prevent terrorist attacks from occurring by cutting off their financial resources.<sup>402</sup> A successful war on terror must reach “deep into the financial heart of terrorism” because terrorists are able to accomplish their violent attacks with very little money, which means they can plan a number of them.<sup>403</sup> For instance, while the 9/11 attacks cost al-Qaeda approximately \$400,000-\$500,000,<sup>404</sup> the London transit bombings on July 7, 2005, cost terrorist only

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<sup>398</sup> Richard K. Gordon, *Losing the War Against Dirty Money: Rethinking Global Standards on Preventing Money Laundering and Terrorism Financing*, 21 *DUKE J. COMP. & INT'L L.* 503, 506 (2011) [hereinafter *Losing the War Against Dirty Money*].

<sup>399</sup> Shan Carter & Amanda Cox, *One 9/11 Tally: \$3.3 Trillion*, *N.Y. TIMES* (Sept. 8, 2011), available at <http://www.nytimes.com/interactive/2011/09/08/us/sept-11-reckoning/cost-graphic.html>.

<sup>400</sup> Andy McSmith, *Home Office: Cost of Fighting Terrorism Triples to £ 3.5bn by 2010*, *INDEPENDENT* (Oct. 10, 2007), <http://www.independent.co.uk/news/uk/politics/home-office-cost-of-fighting-terrorism-triples-to-pound35bn-by-2010-396473.html>.

<sup>401</sup> Task Force, *Council on Foreign Relations, Terrorist Financing*, 2-3 (2002) [hereinafter *CFR, TERRORIST FINANCING*], available at <http://www.cfr.org/terrorist-financing/terrorist-financing/p5080>; see also 9/11 COMMISSION REPORT, *supra* note 397, at 169 (“The plotters’ tradecraft was not especially sophisticated, but it was good enough. They moved, stored, and spent their money in ordinary ways, easily defeating the detection mechanisms in place at the time.”); U.S. Gen. Accounting Office, *GAO-04-163, Terrorist Financing: U.S. Agencies Should Systematically Assess Terrorists’ Use of Alternative Financing Mechanisms* 9 (2003) (“To move assets, terrorists use mechanisms that enable them to conceal or launder their assets through nontransparent trade or financial transactions such as charities, informal banking systems, bulk cash, and commodities such as precious stones and metals.”); Michael Jacobson & Matthew Levitt, *Staying Solvent: Assessing Al-Qaeda’s Financial Portfolio*, *JANE’S STRATEGIC ADVISORY SERVS.*, 13 (Nov. 2009), available at <https://www.washingtoninstitute.org/uploads/Documents/opeds/4b28f9a9e2216.pdf> (“Due to the increased international scrutiny, Al-Qaeda has also become far more security conscious in its fundraising activities.”)

<sup>402</sup> Vietlong Nguyen, *Stop the Money, Stop the Attacks: A Categorical Approach to Achieving an International Terrorist Financing Sanction Regime*, 1 *PENN ST. J.L. & INT’L AFF.* 157, 160 (2012).

<sup>403</sup> Shima Baradaran et. al., *Funding Terror*, 162 *U. PA. L. REV.* 477, 480-81 (2014)

<sup>404</sup> See 9/11 COMMISSION REPORT, *supra* note 3, at 13 (noting further that of that sum, “approximately \$300,000 was deposited into U.S. bank accounts of the 19 hijackers”)

about \$15,000.<sup>405</sup> Furthermore, besides direct funds for attacks, terrorist organizations need vast amounts of money for the use of indirect activities to maintain their organization and infrastructure.<sup>406</sup> As terrorist organizations, such as al Qaeda, and now Boko Haram,<sup>407</sup> emerge and wreak havoc, it is just another reminder that countries must follow the money as a means stop terrorist from intensifying their efforts.<sup>408</sup>

This chapter will discuss the importance taking into account the unique features of terrorist financing in order to combat it through anti-money laundering measures. This chapter will first discuss the definition of money laundering and its process.<sup>409</sup> Next, the chapter will move to discuss terrorism and the link between financing terrorism and money laundering.<sup>410</sup> Then, this chapter will examine legislative efforts by both the United States and the United Kingdom and how they have helped lead the world in the fight against terrorism financing, while also discussing weaknesses of each regime.<sup>411</sup>

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<sup>405</sup> Baradaran et. al., supra note 403, at 480.

<sup>406</sup> FATF, Terrorist Financing 8-10 (2008) [hereinafter Terrorist Financing] (outlining various matters which terrorist organizations require funding for).

<sup>407</sup> Boko Haram and U.S. Counterterrorism Assistance to Nigeria, U.S. State Department Fact Sheet (May 14, 2014) (“Boko Haram (BH), a violent Islamist movement that has staged regular attacks in northern Nigeria since 2010).

<sup>408</sup> Kathleen Caulderwood, How Boko Haram Gets Financed: Fake Charities, Drug Cartels, Ransom and Extortion, PM NEWS NIGERIA (May 18, 2014) (discussing the developments in Boko Haram’s funding and noting that if the group was not well funded they would no longer exist).

<sup>409</sup> See infra Section Part II.A.

<sup>410</sup> See infra Section II.B.

<sup>411</sup> See infra Section III, IV.

## Background

### Money laundering what is it?

Estimates have been given that between \$590 billion and \$1.5 trillion is laundered globally every year, making up 2-5% of the world's GDP.<sup>412</sup> Money laundering is “the process by which one conceals the existence, illegal source, or illegal application of income, and then disguises that income to make it appear legitimate.”<sup>413</sup> By having the funds appear to be legitimate, those handling the proceeds are able to have it flow through society without the funds being confiscated or being prosecuted for the act.<sup>414</sup> Money laundering can turn out to be a very profitable and complex enterprise,<sup>415</sup> which makes it a vital tool for organized crime and terrorist alike.<sup>416</sup> Although initial anti-money laundering efforts were aimed at preventing illegal drug trafficking from benefiting from their proceeds,<sup>417</sup> anti-money laundering now targets various criminal activities, including financing terrorist.<sup>418</sup>

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<sup>412</sup> Financial Action Task Force, Frequently Asked Questions, available at <http://www.fatf-gafi.org/pages/faq/moneylaundering> [hereinafter FATF FAQ]; see also The IMF and the Fight Against Money Laundering and the Financing of Terrorism, IMF (Sept. 30, 2013), available at <http://www.imf.org/external/np/exr/facts/aml.htm>. But see id. (remarking that it is impossible to provide a definitive estimate of the amount laundered given the nature of the act itself).

<sup>413</sup> President's Commission on Organized Crime, Interim Report to the President and Attorney General, *The Cash Connection: Organized Crime, Financial Institutions, and Money Laundering* 7 (1984) [hereinafter Interim Report].

<sup>414</sup> Scott Sultzer, *Money Laundering: The Scope of the Problem and Attempts to Combat It*, 63 TENN. L. REV. 143, 148 (1995).

<sup>415</sup> Kevin Scura, *Money Laundering*, 50 AM. CRIM. L. REV. 1271, 1274 (2013)

<sup>416</sup> Ronald K. Noble & Court E. Golombic, *A New Anti-Crime Framework for the World: Merging the Objective and Subjective Models for Fighting Money Laundering*, 30 N.Y.U. J. INT'L L. & POL. 79, 84-85 (1998) (describing the importance of money laundering to organized crime activities); see also Michael D. Hoffer, Note, *A Fistful of Dollars: “Operation Casablanca” and the Impact of Extraterritorial Enforcement of United States Money Laundering Law*, 28 GA. J. INT'L & COMP. L. 293, 294 (2000) (observing that criminal enterprises would only be able to operate at a “small fraction of current levels” without the use of effective money laundering).

<sup>417</sup> See generally Guy Stessens, *Money Laundering: A New International Law Enforcement Model* (2000) (examining the U.N. Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, entered into force on Nov. 11, 1990).

<sup>418</sup> Paul Allan Schott, *Reference Guide to Anti-Money Laundering and Combating the Financing of Terrorism* (2004) (commenting the scope of money laundering).

Regardless of the activity, money laundering tends to involve three steps in order to be successful. These steps are: placement, layering, and integration.<sup>419</sup> Placement is the first step and involves the money launderer to usually place large amounts of “dirty” money into a legitimate enterprise.<sup>420</sup> This is usually accomplished by depositing the funds into a bank account. Exchanging of currency can also be conducted at this initial stage as well. The placement must be done without attracting attention from the financial institution or law enforcement.<sup>421</sup>

After the money has been placed, the funds are then “layered” into various transactions in order to avoid being traced to their origins.<sup>422</sup> The purpose of this step is to “create confusion and complicate the paper trail.”<sup>423</sup> At this point, the funds may be used to purchase other securities, insurance contracts, or other transferable investments. Funds often shift through various financial institutions, being sold or transferred as check, money order, bonds, etc. Shell corporations<sup>424</sup> may also be utilized and the funds can be disguised as a transfer for payment of goods or services.<sup>425</sup>

As the money begins to be used and “cleaned”, they are then integrated into legitimate financial uses, such as bank notes, loans, or other various legal financial instruments.<sup>426</sup> This stage is done to achieve the main goal of laundering money, which is “to create the appearance of legality through additional transactions.”<sup>427</sup> The various transactions help to shield the criminal from any connection to the funds.<sup>428</sup> Furthermore,

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<sup>419</sup> See Sultzer, *supra* note 414.

<sup>420</sup> Teresa A. Adams, *Tacking on Money Laundering Charges to White Collar Crimes: What Did Congress Intend, and What Are the Courts Doing?* 17 GA. ST. U. L. REV. 531, 535 (2000) (describing the three basic stages of money laundering).

<sup>421</sup> Federal Financial Institutions Examination Council, *Bank Secrecy Act/ Anti-Money Laundering Manual* 12 (April 2010) [hereinafter *BSA /AML Manual*].

<sup>422</sup> Adams, *supra* note 420, at 535.

<sup>423</sup> *BSA /AML Manual*, *supra* note 421, at 12.

<sup>424</sup> Baradaran, *supra* note 403, at 492 (explaining that shell corporations are business with no significant assets or ongoing business activities but are able to transfer large amounts of money worldwide).

<sup>425</sup> Schott, *supra* note 418, at 1-8

<sup>426</sup> Adams, *supra* note 420, at 535.

<sup>427</sup> *BSA/AML Manual*, *supra* note 421, at 12.

<sup>428</sup> *Ibid*



as each stage in the money-laundering scheme is completed, it becomes more difficult to detect where the illegal funds are going and who is behind the scheme.<sup>429</sup>

As a means to combat money laundering, the Financial Action Task Force (“FATF”), an intergovernmental organization, was founded in 1989 at the G-7 summit in Paris.<sup>430</sup> Since 9/11, it has become the lead organization to develop and promote measures aimed at combating money laundering and terrorist financing.<sup>431</sup> The FATF provides recommendations to its members and also monitors members’ progress in implementing money laundering laws and regulations.<sup>432</sup> The FATF has issued 40 recommendation on money laundering and 9 Special Recommendations on Terrorist Financing.<sup>433</sup> However, these recommendations are highly regarded as “soft law” because although successful at getting member states to implement them, the recommendations are not required.<sup>434</sup>

### **Financing Terrorism and the Link to Money Laundering**

Terrorist financing is where terrorists use the financial system to fund their illegal activities.<sup>435</sup> The process of money laundering is essential to terrorist in order to avoid detection.<sup>436</sup> Even before the events of 9/11, the United Nations had established the International Convention for the Suppression of the Financing of Terrorism (1999), which provides:

1. Any person commits an offence within the meaning of this Convention if that person by any means, directly or indirectly, unlawfully and wilfully, provides or collects funds with

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<sup>429</sup> Ibid

<sup>430</sup> Michael Martuscello, *The Fatf's Nine Special Recommendations: A Too "Soft" Approach to Combating Terrorism?* 14 *TOURO INT'L L. REV.* 363, 364 (2011).

<sup>431</sup> Alan E. Sorcher, *lost in Implementation: Financial Institutions Face Challenges Complying with Anti-Money Laundering Laws*, 18 *TRANSNAT'L LAW.* 395, 405 (2005).

<sup>432</sup> Seeid.

<sup>433</sup> See Martuscello, *supra* note 430 at 372.

<sup>434</sup> See generally, *id.* (commenting on the ways FATF is able to get members to implement the recommendations but why they are still considered soft law).

<sup>435</sup> Navin Beekarry, *The International Anti-Money Laundering and Combating the Financing of Terrorism Regulatory Strategy: A Critical Analysis of Compliance Determinants in International Law*, 31 *NW. J. INT'L L. & BUS.* 137, 153 (2011).

<sup>436</sup> Baradaran et. al., *supra* note 403 at 488.

the intention that they should be used or in the knowledge that they are to be used, in full or in part, in order to carry out:

(a) An act which constitutes an offence within the scope of and as defined in one of the treaties listed in the annex; or

(b) Any other act intended to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing any act.

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3. For an act to constitute an offence set forth in paragraph 1, it shall not be necessary that the funds were actually used to carry out an offence referred to in paragraph 1, subparagraphs (a) or (b).<sup>437</sup>

Although the U.N. Financing Convention was in existence prior to the events of 9/11, it was not until after the attacks when countries began to bolster their national efforts against money laundering.<sup>438</sup> Global efforts also intensified to combat the financing of terrorism. The United Nations Security Council quickly passed Resolution 1373,<sup>439</sup> which urged states to become parties to the U.N. Financing Convention and condemned terrorism, particularly the financing of terrorist activities.<sup>440</sup> Prior to Resolution 1373, there were only forty-eight states who had signed the Financing Convention, only four of which had actually ratified.<sup>441</sup> Following the Resolution, 84 states signed the Convention, twenty-one of which ratified it.<sup>442</sup>

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<sup>437</sup> International Convention for the Suppression of the Financing of Terrorism, opened for signature Jan. 10, 2000, T.I.A.S. 13075, 2178 U.N.T.S. 38349 [hereinafter Financing Convention].

<sup>438</sup> Richard Gordon, Terrorism Financing Indicators for Financial Institutions in the United States, 44 Case W. Res. J. Int'l L. 765, 769 (2012) [hereinafter Terrorist Financing Indicators].

<sup>439</sup> It is interesting to note that Resolution 1373 was passed under Chapter VII of the U.N. which would make its measures mandatory, however, the Security Council phrased the Resolution in permissive terms.

<sup>440</sup> See S.C. Res. 1373, U.N. Doc. S/RES/1373 (Sept. 28, 2001).

<sup>441</sup> Status of the International Convention for the Suppression of the Financing of Terrorism, United Nations Treaty Collection, <http://treaties.un.org/doc/Publication/MTDSG/Volume%20II/Chapter%20XVIII/XVIII-11.en.pdf> (last visited Oct. 21, 2012).

<sup>442</sup> Ibid.

Still, despite the concern for terrorism, there is a lack of a universal definition to implement into domestic legislation or to utilize in international law.<sup>443</sup> Many countries differ on how they define terrorism and what acts constitute terrorism.<sup>444</sup> However, the FATF has recommended many countries to adopt the definition provided in the U.N. Financing Convention.<sup>445</sup>

Given the various political, religious and national implications, countries still differ on how to define the term.<sup>446</sup> Since 9/11, anti-money laundering measures have been the focus for combating terrorist financing.<sup>447</sup> The initial phase of procuring funds for terrorist can often differ from other organized criminals because terrorist's sources of money may be legitimate rather than illicit.<sup>448</sup> Terrorists frequently use charities and fundraising as a primary method to increase their funding.<sup>449</sup> The reason for this is primarily the *zakat*, one of the five pillars of Islam, is a religious duty for all Muslims to provide some of their income to humanitarian causes.<sup>450</sup> Unfortunately, terrorist organizations have found ways to abuse the *zakat* to help finance their operations.<sup>451</sup> The problem in trying to regulate this duty is that although some knowingly donate to causes that have terrorist aims, many do not.<sup>452</sup>

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<sup>443</sup> See, e.g., *Tel-Oren v. Libyan Arab Republic*, 726 F.2d 774, 795 (D.C. Cir. 1984) (Edwards, J., concurring) (“[T]he nations of the world are so divisively split on the legitimacy [of terrorism] as to make it impossible to pinpoint an area of harmony or consensus.”), cert. den’d, 470 U.S. 1003 (1985); *Flatow v. Islamic Republic of Iran*, 999 F. Supp. 1, 17 (D.D.C. 1998) (citing U.S. Dep’t. of State, *Patterns of Global Terrorism*, at vi, 1, 17 (2003), available at <http://www.state.gov/s/ct/rls/pgtrpt/2002/html/19997.htm>) (“Attempts to reach a fixed, universally accepted definition of international terrorism have been frustrated both by changes in terrorist methodology and the lack of any precise definition of the term ‘terrorism’”).

<sup>444</sup> Schott, *supra* note 418 at 1-4.

<sup>445</sup> FATF, IX Special Recommendations, 2 (2010), <http://www.fatf-gafi.org/dataoecd/8/17/34849466.pdf>.

<sup>446</sup> See Morris, *supra* note 453, at 3 (discussing the benefit of a single definition of terrorism but the problems in achieving such a goal).

<sup>447</sup> See Baradaran, *supra* note 405 at 490.

<sup>448</sup> John D.G. Waszak, *The Obstacles to Suppressing Radical Islamic Terrorist Financing*, 36 *Case W. Res. J. Int’l L.* 673, 675 (2004) (asserting that the difference between money launder of criminal profits and terrorist financing is that criminals clean dirty money while terrorist dirty clean money).

<sup>449</sup> *Terrorist Financing*, *supra* note 406, at 7.

<sup>450</sup> Nina J. Crimm, *The Moral Hazard of Anti-Terrorism Financing Measures: A Potential to Compromise Civil Societies and National Interests*, 43 *WAKE FOREST L. REV.* 577, 581-88 (2008) (explaining the *zakat*).

<sup>451</sup> Waszak, *supra* note 448, at 696.

<sup>452</sup> *Ibid.*

Once funds are obtained, placement or layering of them for terrorist financing can be accomplished through the use of Informal Value Transfer Systems (“IVTS”).<sup>453</sup> Although IVTS is referred to as “underground banking” or as an “alternative” for remittances, neither of these terms describe the system accurately.<sup>454</sup> IVTS networks are able to operate both openly and legally because a majority of their services are actually legitimate and deal with clean money.<sup>455</sup> Additionally, many countries utilize the IVTS network as their main financial system, not as an alternative.<sup>456</sup>

A major example of an IVTS is the Hawala system,<sup>457</sup> which provides fast, inexpensive, reliable and convenient service, which attracts many legitimate customers.<sup>458</sup> Another feature of the Hawala system though is that it leaves little to no trace, which is a benefit to money launders and terrorists alike.<sup>459</sup> In using the Hawala system, no money is actually physically transferred and can be done anonymously.<sup>460</sup> Theoretically, as an IVTS, the Hawala system does fall under the regulatory system within the United States. Thus, they should maintain financial records, file suspicious activity reports and register as a money service business<sup>461</sup> with FinCEN.<sup>462</sup> These regulations never come into practice for many Hawalas who tend to serve immigrant communities which presents language and

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<sup>453</sup> Walter Perkel, Money Laundering and Terrorism: Informal Value Transfer Systems, 41 AM. CRIM. L. REV. 183, 184 (2004) (discussing the importance of IVTS for terrorism). But see Joshua Morris, Vulnerabilities and Responses to Terrorist Financing: An Exploration of Informal Value Transfer Systems (IVTS), Islamic Charities, and Businesses and Financiers, INTERNET J. OF CRIMINOLOGY (2014) available at [http://www.internetjournalofcriminology.com/Morris\\_Vulnerabilities\\_and\\_Responses\\_to\\_Terrorist\\_Financing\\_IJC\\_Jan\\_2014.pdf](http://www.internetjournalofcriminology.com/Morris_Vulnerabilities_and_Responses_to_Terrorist_Financing_IJC_Jan_2014.pdf) (analyzing the lack of evidence to demonstrate that IVTS networks are more susceptible to financing terrorist).

<sup>454</sup> See *id.* at 188.

<sup>455</sup> *Ibid.* at 185, 188.

<sup>456</sup> *Ibid.* at 188.

<sup>457</sup> See Joseph Wheatley, Ancient Banking, Modern Crimes: How Hawala Secretly Transfers the Finances of Criminals and Thwarts Existing Laws, 26 U. PA. J. INT'L ECON. L. 347 (2005) (describing the Hawala as an ancient banking system from the Middle East and South Asia).

<sup>458</sup> *Ibid.*

<sup>459</sup> *Ibid.*

<sup>460</sup> Charles B. Bowers, Hawala, Money Laundering, and Terrorism Finance: Micro-Lending as an End to Illicit Remittance, 37 DENV. J. INT'L L. & POL'Y 379 (2009) (explaining the function and process of the Hawala system).

<sup>461</sup> Colin Watterson, More Flies with Honey: Encouraging Formal Channel Remittances to Combat Money Laundering, 91 TEX. L. REV. 711, 716 (2013) (defining money service businesses to be “nonbank firms that specialize in money transfer services rather than the provision of traditional financial products”).

<sup>462</sup> See *infra* discussion III.A.

cultural barriers for enforcement and compliance with regulations.<sup>463</sup> Law enforcement has trouble monitoring the Hawalas and their existence still puzzles many who do not know the system.<sup>464</sup>

As such, terrorist funds can come from both legitimate sources as well as criminal activities. They may also use informal or formal banking systems to place, layer or integrate the funds. Money laundering schemes are utilized by terrorist organizations in order to conceal their funds and to have the money available to them for future terrorist financing activities.<sup>465</sup> Law enforcement can face several obstacles considering the manner in which terrorist launder money. Primarily, it becomes increasingly difficult because law enforcement may be on the watch for illegal activity when in fact terrorist can often utilize legitimate means in order to fundraise money.<sup>466</sup> Additionally, the various avenues and methods that terrorist can launder the money complicate the problem even more.<sup>467</sup> Accordingly, terrorist financing differs from traditional money laundering in that it often dirties clean money, but it can also clean dirty money when it launders from criminal or illicit activity.<sup>468</sup>

Nevertheless, terrorist financing uses money laundering in similar ways and for similar objectives.<sup>469</sup> The need for significant amounts of money to go undetected is one of the ways in which terrorist use the money laundering process.<sup>470</sup> Even when using legitimate sources, such as money from charities, terrorist must launder the money in order to prevent these sources from being discovered.<sup>471</sup> This purpose is critical to terrorist

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<sup>463</sup> §2.06 Alternative Banking System, CCH Fed. Banking Law Reporter. 2014 WL 989496.

<sup>464</sup> *Ibid.*

<sup>465</sup> Schott, *supra* note 21, at 1-5.

<sup>466</sup> *See* Baradaran, *supra* note 405 at 489 (noting the difficulties for detecting terrorist money laundering).

<sup>467</sup> Stefan D. Haigner et. al., *Combating Money Laundering and the Financing of Terrorism: A Survey*, Economics of Security Working Paper 65 (2012) (conveying the various channels and methods terrorist are able to launder funds).

<sup>468</sup> Paul Fagyal, *The Anti-Money Laundering Provisions of the Patriot Act: Should They Be Allowed to Sunset?* 50 ST. LOUIS U. L.J. 1361, 1363 (2006) (explaining that money laundering for terrorist financing has been viewed as “reverse money laundering” when the money is obtained from a legitimate source and then laundered for illegal purposes).

<sup>469</sup> FATF, *Terrorist Financing* 34 (2008) (observing the similar needs of money laundering and financing terrorism to “mask financial resources and activities from the scrutiny of state authorities”).

<sup>470</sup> *See* Martuscello, *supra* note 430, at 369.

<sup>471</sup> *Ibid.*

financing because it not only helps ensure their benefactors are safe from punishment, but also allows the terrorist to continue to have access to those sources in the future.<sup>472</sup> Terrorists also need to conceal the use of the funds in order to carry out their activities.<sup>473</sup> Consequently, although the aims may be similar, terrorist financing may not always be handled in the same manner as traditional money laundering.<sup>474</sup>

## **Combating the Financing of Terrorism**

The United States and the United Kingdom have both enacted major legislation in an attempt to curtail terrorist financing. These new laws focusing on terrorist financing are due to the terrorist attacks that have occurred since 2000.<sup>475</sup> Both of these countries have help lead the global effort to combat terrorist financing, albeit in distinct ways.<sup>476</sup> The next section reviews the history of each country's legislation, noting their strengths and deficiencies in the war on terror financing.

### **United States**

As stated above, the United States has spent an immense amount of money on military, security and intelligence efforts as a means to combat terrorism.<sup>477</sup> The efforts to tackle terrorist financing in the U.S. grew out of legislation that addressed traditional

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<sup>472</sup> Fagyal, *supra* note 468, at 369.

<sup>473</sup> See Martuscello, *supra* note 430, at 370.

<sup>474</sup> *Ibid.*

<sup>475</sup> Michael Levy, *7/7: The Bombings of 2005 Remembered and Muslim Perspectives*, BRITANNICA Blog (July 7, 2010) (“America has September 11 of 2001. Spain has March 11 of 2004. And, the United Kingdom has July 7 of 2005. All three involved terrorist attacks on transportation networks”).

<sup>476</sup> Laura K. Donohue, *Anti-Terrorist Finance in the United Kingdom and United States*, 27 MICH. J. INT'L L. 303, 309 (2006); see also Baradaran et. al., *supra* note 403, at 502 (arguing that the United States has been more proactive with international efforts than it has with its domestic legislation), Sorcher, *supra* note 431, at 396 (maintaining that the United States has led the world in restricting terrorist financing).

<sup>477</sup> See *supra* note 399 and accompanying text; see also U.S. Dep't of Homeland Sec., *Implementing 9/11 Commission Recommendations: Progress Report 2011*, at 43 (2011) (noting the Department of Homeland Security's progress in executing the recommendations of the 9/11 Commission, including the Commission's recommendation to monitor and curtail terrorist financing); see generally Jena Baker McNeill et al., *39 Terror Plots Foiled Since 9/11: Examining Counterterrorism's Success Stories Backgrounder* Heritage Found, May 20, 2011), at 1, available at <http://www.heritage.org/research/reports/2011/05/39-terror-plots-foiled-since-911-examining-counterterrorism-success-stories>.

organized crime and money laundering. This was because prior to 9/11, the U.S. did not consider financing monitors as a means to combat terrorism.<sup>478</sup>

Money laundering was not a new issue for the U.S. legislature. The Bank Secrecy Act of 1970 (“BSA”) was the first legislative initiative.<sup>479</sup> The BSA required financial institutions<sup>480</sup> to maintain certain records and authorizes the Secretary of the Treasury to require the institutions and persons conducting transactions to file Suspicious Activity Reports (SARs) on the transactions to the Secretary.<sup>481</sup> The financial institutions covered by the BSA were thus required to report each deposit, withdrawal, currency exchange or other payment or transfer that were more than \$10,000.<sup>482</sup> It is not surprising that the BSA was unpopular among financial institutions for the burdensome requirements, which are a strict liability offence if the institution fails to comply.<sup>483</sup> Additionally, the requirements can be seen as ineffective because criminals and terrorist alike would know to simply deposit smaller amounts. However, such behaviour, known as “smurfing,” was than required to be reported by financial institutions as well.<sup>484</sup>

During the 1980s, due to the prevalence of money laundering, led to the enactment of the Money Laundering Control Act of 1986 (“Money Laundering Act”).<sup>485</sup> The Money Laundering Act established liability for any individual who conducts a financial transaction with knowledge that the funds originated from illegal or illicit activity.<sup>486</sup> The Act also set out to prohibit all “monetary transaction[s] in criminally derived property” in excess of \$10,000.<sup>487</sup> The money laundering act drew from various definitions of income from other

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<sup>478</sup> See Donohue, *supra* note 476, at 349 (noting that the U.S. believed terrorist did not require large amounts of money and therefore that there were more effective ways of preventing attacks).

<sup>479</sup> Bank Secrecy Act of 1970, 12 U.S.C. §§ 1829(b), 1951-1959 (2003); 31 U.S.C. §§ 5311-5322 (2003).

<sup>480</sup> 31 U.S.C. § 5312(a)(2) (defining “financial institution” to include, among other things, banks and depository institutions, casinos and card clubs, broker-dealers and investment companies).

<sup>481</sup> 31 U.S.C. § 5313(a).

<sup>482</sup> *Ibid.* at §5313(b).

<sup>483</sup> *Ibid.* at §5321(a).

<sup>484</sup> *Ibid.* at 31 U.S.C. § 5324 (requiring financial institutions to implement compliance procedures to aggregate transactions in order to detect and prevent smurfing).

<sup>485</sup> Money Laundering Control Act of 1986, 18 U.S.C. §§ 1956-57 (2000).

<sup>486</sup> *Ibid.*

<sup>487</sup> *Ibid.* § 1957(a). Monetary transaction is defined under 18 U.S.C § 1957(f)(1), as a “deposit, withdrawal, transfer, or exchange, in or affecting interstate or foreign commerce, of funds or a monetary instrument ...

legislative acts that were implemented to address organized crime such as drug trafficking, prostitution, gambling.<sup>488</sup>

After 9/11, the United States shifted its focus to actually tracking terrorist financing and implementing measures to accomplish this aim.<sup>489</sup> Following the 9/11 attacks, the U.S. passed the Patriot Act to address domestic terrorism.<sup>490</sup> The Patriot Act was legislated in order to improve the government's anti-money laundering efforts and tackle terrorist financing.<sup>491</sup> The Patriot Act not only strengthened the existing BSA system by adding to the types of financial institutions covered, but also conferred on the Treasury the authority to examine the financial institutions and ban suspect accounts.<sup>492</sup> The Act also turned failure to comply with the BSA into a criminal offence rather than civil.<sup>493</sup> The financial institutions were also required to know their customers better, using their full and accurate name and to maintain records of date of births, social security number, and passport number.<sup>494</sup> The financial institutions covered by the Act were also required to file various new SARs, along with non-financial trades or businesses.<sup>495</sup> Additionally, money service businesses without licenses were also brought into the regulatory regime.<sup>496</sup> To further

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by, through, or to a financial institution ... 'but does not include' any transaction necessary to preserve a person's right to representation as guaranteed by the sixth amendment to the Constitution."

<sup>488</sup> Andres Rueda, *International Money Laundering Law Enforcement & the USA Patriot Act of 2001*, 10 *MSU-DCL J. INT'L L.* 141, 147-49 (2001) (relaying the scope of the Money Laundering Act).

<sup>489</sup> Donohue, *supra* note 476, at 368.

<sup>490</sup> *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act)*, Pub. L. No. 107-56, 115 Stat. 272 (codified as amended in scattered sections of 8, 15, 18, 22, 31, 42, 49, and 50 U.S.C.). [hereinafter *USA PATRIOT Act*] (defining domestic terrorism as "acts dangerous to human life that are a violation of the criminal laws of the United States or of any State" intended to "intimidate or coerce a civilian population", "influence the policy of a government by intimidation or coercion" or "affect the conduct of a government by mass destruction, assassination, or kidnapping" that are conducted primarily within the jurisdiction of the United States).

<sup>491</sup> See Sorcher, *supra* note 431, at 396-97 (commenting that the under the PATRIOT Act increased the U.S. government's powers to combat money laundering and terrorist financing).

<sup>492</sup> Eric J. Gouvin, *Bringing Out the Big Guns: The USA Patriot Act, Money Laundering, and the War on Terrorism*, 55 *BAYLOR L. REV.* 955, 970 (2003).

<sup>493</sup> Guiora & Field, *supra* note 396, at 78.

<sup>494</sup> Patriot Act §326.

<sup>495</sup> *Ibid.* §§356(a)-(b), 365.

<sup>496</sup> *Ibid.* at §373; see also Guiora & Field, *supra* note 396, at 83 (stating the importance of including unlicensed money businesses to fight the abuse of informal value transfer systems).



strengthen the efforts, the unlicensed entities are required to verify the identity of any customer or beneficiary receiving money transfer of more than \$3,000.<sup>497</sup>

The Patriot Act reinforces the sanctions for failing to comply with the anti-money laundering provisions by: (1) requiring federal banking agencies to take into account a financial institution's record of anti-money laundering efforts when reviewing applications in for a bank merger or acquisition;<sup>498</sup> (2) implementing civil and criminal penalties of up to \$1 million for financial institutions for violations of the Patriot Act's money laundering provisions;<sup>499</sup> and (3) authorizing the Secretary to mandate a U.S. correspondent bank to dissolve correspondent banking relationships with a foreign bank that fails to comply with or contests a U.S. summons or subpoena.<sup>500</sup> Thus, the provisions in their totality provide for the Patriot Act's focus on combating terrorist financing.<sup>501</sup> The regulatory requirements of due diligence, record keeping, and reporting by both formal financial institutions and informal funds transfer systems are designed to detect and criminalize money laundering as well as providing material support to terrorist organizations as a means to fight terrorist financing.<sup>502</sup>

Beyond legislative initiatives, the United States also established the Financial Crimes Enforcement Network ("FinCEN"), which works with domestic law enforcement agencies to ensure compliance with legislation.<sup>503</sup> The international counterpart to FinCEN became the Office of Foreign Assets Control ("OFAC"), whose purpose is to disrupt and freeze illicit funds internationally.<sup>504</sup>

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<sup>497</sup> Amendment to the Bank Secrecy Act Regulations Relating to Recordkeeping for Funds Transfers and Transmittals of Funds by Financial Institutions, 60 Fed. Reg. 220, 229-31 (1995)

<sup>498</sup> Patriot Act § 327(b)(1)(B).

<sup>499</sup> *Ibid.* § 363.

<sup>500</sup> *Ibid.*

<sup>501</sup> *See* Title III: The International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001; see also Donohue, *supra* note 476, at 370-378 (providing detailed account of the Patriot Act measures)

<sup>502</sup> John D.G. Waszak, The Obstacles to Suppressing Radical Islamic Terrorist Financing, 36 CASE W. RES. J. INT'L L. 673, 686 (2004).

<sup>503</sup> Financial Crimes Enforcement Network, U.S. Dep't of the Treas., About FinCEN Mission, available at [http://www.fincen.gov/af\\_mission.html](http://www.fincen.gov/af_mission.html) (stating its mission is to "safeguard the financial system from the abuses of financial crime, including terrorist financing, money laundering, and other illicit activity").

<sup>504</sup> U.S. Treasury, Office of Foreign Assets Control, available at <http://www.treas.gov/offices/enforcement/ofac/> (establishing the mission of OFAC is to administer and enforce

## United Kingdom

The British government has designated 58 organizations as a terrorist and banned them. 44 of these organizations were banned under the Terrorism Act of 2000. Two of these were also banned under the Terrorism Act of 2006 for “glorifying terrorism” other than the far right new Nazi National Action, the other fourteen organizations operate (for the most part) in Northern Ireland, and were banned under previous legislation.<sup>505</sup> The United Kingdom has greater experience with terrorist financing due to its battles with the Irish Republican Army (“IRA”).<sup>506</sup> Since 1974, the U.K. has had specialized terrorist legislation.<sup>507</sup> Initially, legislation in the U.K. focused on robberies and tax fraud, but shifted to more sophisticated organized crime, such as drug trafficking, in its effort to curtail terrorist financing.<sup>508</sup> In 2000, the United Kingdom implemented their first permanent legislation to combat terrorism, the Terrorism Act, which applied to terrorist acts<sup>509</sup> in the U.K. in general as well as in Northern Ireland and international acts.<sup>510</sup> A major component of the 2000 Act is its criminalization of terrorist financing.<sup>511</sup> The Terrorism Act did allow law enforcement to ask financial institutions for customer information, however in order to obtain the information, the law enforcement agents were required to go through a warrant process.<sup>512</sup> Furthermore, the type of information that could

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economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction).

<sup>505</sup> See [https://en.wikipedia.org/wiki/Terrorism\\_in\\_the\\_United\\_Kingdom#cite\\_note-TERRORLIST-1](https://en.wikipedia.org/wiki/Terrorism_in_the_United_Kingdom#cite_note-TERRORLIST-1)

<sup>506</sup> Guiora and Field, *supra* note 396, at 93.

<sup>507</sup> Prevention of Terrorism (Temporary Provisions) Act, 1974, c. 56 (U.K.); see generally Select Committee on the Constitution, *Fast-Track Legislation: Constitutional Implications and Safeguards*, 2008-9, H.L. 116-II, at 178 (U.K.), available at <http://www.publications.parliament.uk/pa/ld200809/ldselect/ldconst/116/116ii.pdf> (noting that the 1974 was a temporary measure in response to the Birmingham pub bombings).

<sup>508</sup> *Ibid.*

<sup>509</sup> Terrorism Act, 2000, c. 11, §1 (defining terrorism as an action or threat that (i) involves serious violence against a person or damage to property, endangers a person's life, creates a serious risk to the health or safety of the public or a section of the public, or is designed seriously to interfere \*660 with or disrupt an electronic system; (ii) is made for the purpose of advancing a political, religious, racial, or ideological cause; and (iii) is designed to influence the government or an international governmental organization or to intimidate the public or a section of the public.

<sup>510</sup> See Terrorism Act, 2000, c. 11, §62 (U.K.)

<sup>511</sup> *Ibid.* c. 11, §15-18 (U.K.) (listing fundraising, use a possession of property, and money laundering as acts that count as financing terrorism).

<sup>512</sup> *Ibid.* §5, schedule 6

be obtained was limited.<sup>513</sup> The judicial protections limited the older legislation, highlighting the importance of due process in the fight against terrorism.<sup>514</sup>

The principle legislation relating to money laundering is now the POCA 2002 which has also been amended on many occasions; most recently in the Serious Crime Act 2015.<sup>515</sup> However, there are also important provisions in the Terrorism Act 2000, the Anti-terrorism, Crime and Security Act 2001 and the Terrorism (United Nations) Order 2001. Following the 9/11 attacks in the United States, the United Kingdom sought to further their counterterrorist legislation.<sup>516</sup> This led to the implementation of the 2001 Anti-Terrorism, Crime and Security Act (“ATCSA”).<sup>517</sup> The ATCSA authorized the State to confiscate any money that was believed to be associated with terrorist operations, regardless of whether a court brought a proceeding in relation to the money.<sup>518</sup> The ATCSA disregarded the judiciary’s role in freezing assets of entities that were not within the United Kingdom.<sup>519</sup> The ATCSA also amended the Terrorism Act of 2000 by authorizing law enforcement to apply for an open warrant, which gave the agents the power to conduct open ended investigations rather than undergoing the warrant procedures whenever a terrorist related matter arose.<sup>520</sup> It became a criminal offence whenever any person in the “regulated system” failed to notify law enforcement when there were reasonable grounds to suspect a person of a terrorist offence and laundering terrorist proceeds.<sup>521</sup>

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<sup>513</sup> *Ibid.*

<sup>514</sup> *See* Donohue, *supra* note 476, at 340.

<sup>515</sup> Barry Rider. *Market Abuse and Insider Dealing*, 3th Edition, p.186. (Bloomsbury Professional Ltd. 2016)

<sup>516</sup> *Ibid.* at 344.

<sup>517</sup> Anti-Terrorism, Crime and Security Act, 2001, Ch. 24, Part I [hereinafter ATCA]. The new provisions replaced §24 with §31 of the Terrorism Act 2000.

<sup>518</sup> *Ibid.*

<sup>519</sup> *Ibid.* Ch. 24, Part II.

<sup>520</sup> Donohue, *supra* note 476, at 344.

<sup>521</sup> ATCA Part III.

After the 2005 London bus bombings,<sup>522</sup> Parliament felt the need to once again strengthen its counterterrorism efforts which led to the Terrorism Act of 2006 (“2006 Act”).<sup>523</sup> The 2006 Act, while relying on the 2000 Act’s definition of terrorism, also expanded the type of offences that can be criminalized by including the encouragement of terrorism,<sup>524</sup> glorification of terrorist activities<sup>525</sup> and the distribution of “terrorist publications.”<sup>526</sup> Consequently, the 2006 Act intensified the “flexibility of [its] proscription regime.”<sup>527</sup> The 2006 Act also expanded upon the 2000 Act’s prohibition on terrorist organizations.<sup>528</sup> The Act has been found to go further than any other legislation of its kind in the United Kingdom.<sup>529</sup>

### **Are these Efforts Effective?**

The various methods implemented by the United States and the United Kingdom do provide obstacles to terrorist financing. The due diligence requirements to “know your customer”, the monitoring of financial records as well as the other regulatory actions raise

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<sup>522</sup> See House of Commons, Report of the Official Account of the Bombings in London on 7th July 2005, 2005-06 (2005) H.C. 1087, at 2 (U.K.), available at <http://www.official-documents.gov.uk/document/hc0506/hc10/1087/1087.pdf> (detailing the bombings that occurred in London which killed dozens of people).

<sup>523</sup> Sudha Setty, What’s in A Name? How Nations Define Terrorism Ten Years After 9/11, 33 U. PA. J. INT’L L. 1, 38 (2011).

<sup>524</sup> See 675 Parl. Deb., H.L. (5th ser.) (2005) 1385 (asserting that the encouragement of terrorism offence “deal[s] with those who incite terrorism [indirectly rather than through direct aid] but who nevertheless contribute to creating a climate in which impressionable people might believe that terrorism was acceptable).

<sup>525</sup> Terrorism Act, 2006, c. 11, §§ 1, 3 (U.K.) (identifying statements that are considered direct or indirect statements of encouragement to commit, prepare, or instigate acts of terrorism).

<sup>526</sup> *Ibid.* at §2(5) (a-b) (establishing a “terrorist publication” will be determined “in relation to particular conduct” a) “at the time of that conduct” and b) taking into account the publication’s contents as a whole and the circumstances in which such conduct occurs).

<sup>527</sup> See Home Office, Terrorism Act 2006, available at <http://www.homeoffice.gov.uk/security/terrorism-and-the-law/terrorism-act-2006>.

<sup>528</sup> Terrorism Act, 2006, c. 11, pt. 2, §21(5B) (a-b). (determining that a statement by a terrorist organization may result in that organization’s proscription: if there are persons who may become aware of it who could reasonably be expected to infer that what is being glorified, is being glorified as: (a) conduct that should be emulated in existing circumstances, or (b) conduct that is illustrative of a type of conduct that should be so emulated).

<sup>529</sup> Michael C. Shaughnessy, Praising the Enemy: Could the United States Criminalize the Glorification of Terror Under an Act Similar to the United Kingdom’s Terrorism Act 2006?, 113 PENN ST. L. REV. 923, 930-31 (2009) (illustrating the variety of other terrorism-related acts sanctioned by the 2006 Act such as criminalizing preparation of terrorist acts, training for terrorism, and presence at a terrorist training camp, possessing or misusing radioactive materials, or making terrorist threats related to nuclear facilities).

awareness of the possibility of terrorist financing.<sup>530</sup> However, it is debatable to what extent these measures are benefiting the combat of terrorist financing.<sup>531</sup> In practice, the fact that many of the U.K. and U.S. counterterrorist initiatives developed from anti-money laundering hinders their effectiveness.<sup>532</sup> Although the U.K had been dealing with terrorist acts for some time now, their pre-9/11 legislation was still focused on traditional money laundering. Similarly, the U.S. applied their anti-money laundering tools and simply relabelled them to combat terrorist financings. Though there are similarities between money laundering and terrorist financing as discussed above, the differences must be addressed in order for a system to be effective, for the state to truly be able to combat terrorist acts, and for the system to be fair to all those regulated.

As an example, although the United States money laundering regulations were not designed to pick up on terrorist activity prior to 9/11, the system was still very similar to what has developed from the Patriot Act, but it still failed to discover the 9/11 plot. The 9/11 Commission found that the nineteen hijackers who were responsible for the 9/11 attacks had actually opened bank accounts, established inter-connected drawing rights, received various international money transfers and did not seem to worry whether or not their financial activity would attract unwanted attention.<sup>533</sup> The anti-money laundering tools did not catch any of the hijackers' behaviour. In fact, they did not conduct their financial activity in any manner that would be viewed as illegal or out of the ordinary.<sup>534</sup> Even if the hijackers were to have gone about with their financial plans after the heightened regulations following 9/11, they would probably not have been discovered.<sup>535</sup>

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<sup>530</sup> Richard Barrett, Preventing the Financing of Terrorism, 44 Case W. Res. J. Int'l L. 719, 721 (2012).

<sup>531</sup> See Donohue, *supra* note 476, at 390 (commenting that neither the United States nor United Kingdom has been successful in thwarting terrorist operations).

<sup>532</sup> *Ibid.*

<sup>533</sup> John Roth, Douglas Greenburg & Serena Wille, Monograph on Terrorist Financing: Staff Report to the Commission 52-53 (2004) [hereinafter Staff Report] (detailing an extensive overview of the funding tools prior to 9/11).

<sup>534</sup> Barrett, *supra* note 530, at 721.

<sup>535</sup> *Ibid.*, see also 9/11 COMMISSION REPORT, *supra* note 397, at 169 ("The plotters' tradecraft was not especially sophisticated, but it was good enough. They moved, stored, and spent their money in ordinary ways, easily defeating the detection mechanisms in place at the time").

The 9/11 hijackers highlight a very specific problem to anti-terrorist funding, namely there must be something more for financial institutions to look for in order to make the link to terrorist financing. As such, identifying clients, creating client profiles and monitoring their activity is insufficient when the regulated institutions lack guidance on what they actually should be watching for.<sup>536</sup> While every terrorist act requires funding, and more often than not they will act within the regulated financial industry, it is not helpful when the legislative and regulatory tools do not provide proactive measures to identify the danger.<sup>537</sup>

### **Financial Reporting and Regulations**

Financial agencies have long provided anti-money laundering efforts since before 9/11. The post 9/11 regulations have expanded their reach and caused a misfit in handling the burden and has not been as effective as they should or could be in preventing terrorist financing.<sup>538</sup> For example, the Financial Crimes Enforcement Network, or FinCEN, has been transformed from an office that monitored the financial transactions of criminals into one that looks for similar transactions by terrorists.<sup>539</sup> However, as noted, these transactions or even behaviour may not be similar and can be more difficult to track or discover. The result is that in theory, FinCEN looks for a financial lead that will help investigators and prosecutors discover terrorist.<sup>540</sup> Unfortunately, in practice, the agency does little more than policing of the reports of the financial institutions covered by the BSA and the Patriot Act.<sup>541</sup>

As the United Kingdom and United States have turned to heavy regulation and criminalization of financial institutions who fail to report, there has been an increase in suspicious activity reports in both countries. In 2004, the Economist stated, “banks in America and elsewhere are trying to cover themselves by filing even more ‘suspicious activity reports.’ Regulators are swamped with information. Alas, most of it is

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<sup>536</sup> FATF, Guidance for Financial Institutions in Detecting Terrorist Financing 3 (2002) (“[i]t should be acknowledged...that financial intuitions will probably be unable to detect terrorist financing as such”).

<sup>537</sup> See Barrett, supra note 530, at 722 (reiterating the importance of financial institutions to have an idea of what information would be useful to detect).

<sup>538</sup> David Zaring & Elena Baylis, Sending the Bureaucracy to War, 92 IOWA L. REV. 1359, 1410 (2007).

<sup>539</sup> Ibid.

<sup>540</sup> Ibid.

<sup>541</sup> Ibid.

useless.”<sup>542</sup> The increase of SARs has overwhelmed the regulators in both countries, and many are unsure of their value at times.<sup>543</sup> While there are a number of SARs being filed, the number of successful prosecutions is limited.<sup>544</sup> As a result, what is actually occurring in the combat of terrorist financing is an overflow of false positives.<sup>545</sup> Nevertheless, effective and dependable anti-terrorist financing measures need the private sector and their financial reports.<sup>546</sup> The regulated financial institutions are where terrorist are more likely to become noticed because although terrorist financing is not identical to money laundering, the techniques and stages are still the same.<sup>547</sup> Financial institutions are best to spot terrorist financing because they know their clients, what their clients are spending money on, how often and when. Thus, they provide a wealth of knowledge.<sup>548</sup> However, banks and other institutions covered by regulations know about the same as the state when it comes to terrorism.<sup>549</sup> Unfortunately, many do not learn about the way a terrorist is funding its operations until something happens and financing of these operations hardly are the same.<sup>550</sup>

This discussion is not to conclude that the financial regulatory tools that the United Kingdom and the United States are completely ineffective. Overall, it is difficult to determine and evaluate the situation with little evidence because of the very nature of money laundering and terrorist financing.<sup>551</sup> Within months of issuing Executive Order 13,244<sup>552</sup> and the Patriot Act, the Bush Administration declared victory for the United

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<sup>542</sup> Coming Clean; Money-laundering, *ECONOMIST* (U.S. Edition), Oct. 16, 2004, available at <http://www.economist.com/node/3292933>.

<sup>543</sup> John Adams, Anti-Money Laundering: Diligence is Getting Pretty Pricey, *Bank Technology News*, Aug. 2007), available at <http://www.dominion-advisors.com/press/in-the-news/2007/anti-money-laundering-diligence-getting-pretty-pricey> (“Frustration mounts that ... [the suspicious transaction reports] filed were of no use to apathetic or overwhelmed government authorities”)

<sup>544</sup> See *Losing the War Against Dirty Money*, supra note 398 at 543.

<sup>545</sup> *Ibid.*

<sup>546</sup> Barrett, supra note 530, at 730.

<sup>547</sup> See *Terrorist Financing Indicators*, supra note 438, at 795 (concluding that fourteen of the twenty-four cases with sufficient financial information existed used traditional money laundering methods).

<sup>548</sup> *Ibid.*

<sup>549</sup> *Ibid.*

<sup>550</sup> Barrett, supra note 530, at 730.

<sup>551</sup> See generally Morris, supra note 453 (providing reasons why it is difficult to determine the extent financing terrorism should be the focus because of the lack of evidence).

<sup>552</sup> See Staff Report, supra note 533, at 45 (explaining that the two goals of the Executive Order were to halt funding to al Qaeda and to let the public know action was being taken).

States in combating terrorist financing.<sup>553</sup> Recently, President Obama also claimed that al Qaeda was diminishing.<sup>554</sup> Also, as recent developments in al Qaeda and other terrorist groups have demonstrated, there has not been a victory or a diminishing threat.<sup>555</sup>

### **Effect on Privacy and Civil Rights**

In addition to the practical implications, the tools used to fight terrorist financing and money laundering also brings with it other issues. The regulations implemented by the United States and United Kingdom, while not as effective in fighting terrorist financing, have many financial privacy issues along with an effect on civil rights. Privacy issues are under siege now that the Patriot Act allows the federal government to request and obtain sensitive and private data without a warrant, so long as the agency can fit the investigation into one of the two hundred offences listed.<sup>556</sup> Obviously such actions put financial institutions ability to safeguard information into question.<sup>557</sup> With strict penalties for failure to comply, financial institutions may also report information voluntarily in their suspicious activity reports.

The First Amendment to the Constitution of the United States protects free speech, which includes the solicitation of funds, which has been viewed as essential for the exchange of information and ability of citizens to support various positions.<sup>558</sup> However,

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<sup>553</sup> See, e.g., U.S. Dep't of the Treas., Contribution by the Department of the Treasury to the Financial War on Terrorism, Factsheet 6 (Sept. 2002) (declaring, "Our war on terror is working--both here in the United States and overseas ... al Qaeda and other terrorist organizations are suffering financially as a result of our actions. Potential donors are being more cautious about giving money to organizations where they fear the money might wind up in the hands of terrorists. In addition, greater regulatory scrutiny over financial systems around the world in the future may identify those who would support terrorist groups or activities."); Victor Mallet, Terrorist Funds "Being Squeezed," FIN. TIMES (LONDON), Apr. 11, 2002, at 12 (quoting Paul O'Neill's claims that the United States has been successful in its fight against terror financing); U.S. Says al Qaeda Hurting for Funds, REUTERS, May 18, 2005, (Treasury Undersecretary Stuart Levey announcing that al Qaeda was in financial difficulties).

<sup>554</sup> Remarks by the President at the National Defence University, May 23, 2013, available at <http://www.whitehouse.gov/the-press-office/2013/05/23/remarks-president-national-defence-university> (claiming that al Qaeda is on the "path to defeat").

<sup>555</sup> Barbara Starr, Unsettling Video Shows Large al Qaeda Meeting in Yemen, CNN (Apr. 16, 2014) available at <http://www.cnn.com/2014/04/15/world/al-qaeda-meeting-video/> (remarking on a video which demonstrates "the largest and most dangerous gathering of al Qaeda in years")

<sup>556</sup> Donohue, *supra* note 476, at 407.

<sup>557</sup> Rob Garver, Will USA Patriot Act Prove a Recipe for Trouble? Government Access to Banking Information vs. Right to Privacy, *American Banker*, Apr. 23, 2002, at 10.

<sup>558</sup> *Schaumburg v. Citizens for a Better Env't*, 444 U.S. 620 (1980).



today there are serious risks if one chooses to support an Islamic charity or to do business with Islamic or Arab entities.<sup>559</sup> After new terrorist financing legislation was implemented in the United States, mere association with these entities could lead to assets being frozen or rejection from financial institutions.<sup>560</sup>

The United Kingdom goes a step further in its impact on civil rights. By criminalizing speech that is considered encouragement of terrorist activities or glorification, the U.K.'s 2006 Act has received a great deal of criticism.<sup>561</sup> Critics argue that the 2006 Act does not adequately address conduct that is covered by the offence.<sup>562</sup> Further, they state the vagueness of the definition along with the terms used to describe the offence covers a wide variety of conduct which provides a chilling effect and could lead to self-censorship.<sup>563</sup> Both the U.S. and U.K. virtually drop intent as an element for terrorist financing. This can be problematic for privacy issues, civil rights and also property matters (i.e. frozen assets). With low burdens to prove association or that a person has encouraged terrorist, many individuals are put at risk for abuse of the state.<sup>564</sup> This also implicates an individual's right to freedom of religion.<sup>565</sup>

As it can be noted, there are a myriad of interests involved in efforts to combat terrorist financing. There is a need for states to not only implement proactive legislation in order to achieve national security interests, but there is also a need to balance individual civil rights that are connected to these concerns. This is a two-fold effort. First, the government must ensure that it implements effective, but that their measures are not overly broad. Second, they must ensure that they are respecting the liberties of people and the market.

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<sup>559</sup> Donohue, *supra* note 476, at 406.

<sup>560</sup> *Ibid.*

<sup>561</sup> Ellen Parker, Implementation of the U.K Terrorism Act 2006-the Relationship Between Counterterrorism Law, Free Speech, and the Muslim Community in the United Kingdom Versus the United States, 21 *EMORY INT'L L. REV.* 711, 749 (2007).

<sup>562</sup> *Ibid.*

<sup>563</sup> *Ibid.* (stating that this would be in violation of the European Convention on Human Rights).

<sup>564</sup> *Ibid.*

<sup>565</sup> Guiora & Field, *supra* note 396 (providing an overview of freedom of religion issues).

## Conclusion

Terrorism has not been defeated or diminished. While there have been significant measures implemented to defund terrorist activity, there is still much to be done.<sup>566</sup> Terrorists have the ability to obtain large amounts of money and perform atrocities that require very little funding. Terrorists are able to adapt quick and stay ahead of regulators and legislators by going unnoticed amongst the myriad of laws that are aimed at stopping them. While terrorist funding utilizes the same techniques as money launderers, and they may share the same objectives, more or less, it is insufficient to base an entire anti-terrorist funding regime around traditional anti-money laundering mechanisms. It is critical to observe the similarities while also taking note of the differences in the two schemes.

Counterterrorism still holds a place in traditional mechanism such as the military, law enforcement, and intelligence mechanisms. However, the funding of terrorist organizations needs to be made a top priority as well. This could be done through new, specialized anti-terrorism agencies.<sup>567</sup> This would enable the focus to be targeted directly at how terrorists procure funds and move them through the system. This is critical considering the vast amount of channels terrorist organizations have at their disposal. Specialized agencies would also hone in on what makes terrorist financing unique from money laundering.

Furthermore, financial institutions covered by the post-9/11 laws and regulations need to be provided further guidance on how to monitor their businesses. It is not enough that financial institutions report every transaction for fear of being penalized. The laws need to work smarter, rather than harder. Guidance must be provided on how to link transactions with potential terrorists. At the moment, institutions have become confused and are unable to distinguish legitimate transactions from those that must be reported.<sup>568</sup> This overloads

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<sup>566</sup> See generally Baradaran, *supra* note 403 (discussing the gaps in the system through the experiment of opening a shell company).

<sup>567</sup> Zaring & Baylis, *supra* note 538, at 1426.

<sup>568</sup> Watterson, *supra* note 461, at 732.

the agencies tasked to filter these reports and provides little security in preventing or catching terrorist activity.

Additionally, as this chapter has noted, more effective measures towards other means of terrorist financing outside of the formal institutions must be addressed. Charities and non-profits should be considered and new oversight measures should be implemented. However, any such measures must be done in recognition of the delicate balance between government interest and individual rights. The identification of Informal Value Transfer System is also crucial in a regime to combat terrorist financing. By identifying these entities, regulators can ensure compliance with the various laws to gain assistance and information for potential threats.

Combating terrorist financing must be at the forefront of governments around the world. It is insufficient that only a few implement the various measures that the United States and the United Kingdom have. Terrorist financing is a global crime. Funds move across the world through a variety of channels. In “dirtying” the clean money they obtain, the money can come from anywhere or go anywhere. Other countries must also be on the watch for suspicious behaviour and address threats accordingly. Countries in general also need to identify more effective ways to measure their successes and recognize their failures in implementing counterterrorist measures. Furthermore, countries need to be able to adapt just as quickly as terrorist organizations do. However, any measures taken must be proportionate to the threat, and not overly broad so as to compromise individual rights. Sharing information on what other countries have found will also be vital. The United States and United Kingdom have led the forefront on combating terrorist financing and will continue to do as they evaluate their own methods.

Terrorist organizations have been leveraging cyber technologies such as the internet to enable terrorist activities, also using cyber to generate revenue and support. Therefore, the next chapter will examine the cybercrime and the role of the International Financial Institutions in combating cybercrime to promote stability.

## CHAPTER 4

### CYBERCRIME

#### Introduction

Financial institutions are increasingly shifting their operations to cyberspace, as cyber-attacks against financial institutions generally take advantage of a mix of technical and human vulnerabilities.<sup>569</sup> Financial crimes are increasingly turning into cybercrimes,<sup>570</sup> as the Internet and digital world becomes more sophisticated, so do cybercrimes.<sup>571</sup> Cyber criminals have also become more sophisticated as the trend of cybercrimes continues to grow.<sup>572</sup> Both organizations and individuals alike are put at risk for fraud as the convergence between the two crimes increases.<sup>573</sup> The concern regarding cyber financial crimes also derives from its global nature.<sup>574</sup> The internet was originally developed in order to facilitate sharing of data, research and statistics between the United States and Europe.<sup>575</sup> Now, the internet controls a large portion of peoples' lives all over the world.<sup>576</sup> The growth of internet uses thus has contributed significantly to the burgeoning of cybercrime and fraudulent activity.<sup>577</sup> In the United States, it has been estimated that the

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<sup>569</sup> Financial stability in the digital era (Banque de France. Financial Stability Review. No 20. April 2016) available at

[https://www.banquefrance.fr/fileadmin/user\\_upload/banque\\_de\\_france/publications/Revue\\_de\\_la\\_stabilite\\_financiere/RSF20/FSR20\\_5\\_Gaumer.pdf](https://www.banquefrance.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/RSF20/FSR20_5_Gaumer.pdf)

<sup>570</sup> Ibid.

<sup>571</sup> Michael Cohn, Financial Crimes Increasingly Become Cybercrimes, Accounting Today, Mar. 4, 2013) available at [http://www.accountingtoday.com/debits\\_credits/Financial-Crimes-Increasingly-Become-Cybercrimes-65942-1.html](http://www.accountingtoday.com/debits_credits/Financial-Crimes-Increasingly-Become-Cybercrimes-65942-1.html).

<sup>572</sup> See 2014 Global Economic Crime Survey 28 (PwC 2014) [hereinafter, Economic Crime Survey] available at <http://www.pwc.com/gx/en/economic-crime-survey/index.jhtml>.

<sup>573</sup> Paul Henninger, Cyber Crime and Financial Crime: The Two Become One, Nov. 15, 2013 Wired Innovation Insights Blog available at <http://insights.wired.com/profiles/blogs/cyber-crime-and-financial-crime-the-two-become-one#axzz37vUNNjaI>.

<sup>574</sup> Vikram & Bhat & Lincy Francis Therattil, Transforming Cybersecurity: New Approaches for an Evolving Threat Landscape 1 (Deloitte 2014) available at [http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/us\\_fsi\\_Transformingcybersecurity\\_021114.pdf](http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/us_fsi_Transformingcybersecurity_021114.pdf) (noting that cyber risk is now the world's third corporate risk priority overall in 2013)

<sup>575</sup> Phil Butler Cyber Crime, Financial Fraud and Money Laundering: Understanding the New Threat Landscape 1 (Thomas Reuter Accelus 2013) available at <http://acceluscdn.thomsonreuters.com/accelus-pdf/GRC00331-Cybercrime-Phil-Butler.pdf>.

<sup>576</sup> Ibid.

<sup>577</sup> Ibid.

cost of cybercrime is as much as \$100 billion dollars per year,<sup>578</sup> while in the United Kingdom, estimates have been found at £27 billion per year.<sup>579</sup> However, experts have difficulty calculating the exact amount of damages caused by cyber financial crimes due to: (1) the lack of a concise definition of cybercrime;<sup>580</sup> (2) the reluctance of companies to report incidents due to fear of losing consumer confidence;<sup>581</sup> (3) the dual system of prosecution;<sup>582</sup> and (4) the trouble of actual detection. Cyber criminals often seek personal and financial data for fraudulent objectives.<sup>583</sup> Thus, cybercrimes has become an integral part of any discussion on fraud.<sup>584</sup> The problem arises that many cyber criminals, who are located all over the world, are undeterred by the prospect of arrest or prosecution.<sup>585</sup> Cyber Criminals are difficult to detect and pose one of the greatest threats to the financial health of businesses, to the consumer confidence, and to nations' security.<sup>586</sup> Studies have also shown that the financial sector is the most attractive target to cyber criminals.<sup>587</sup> Large scale data breaches enable cyber criminals to access a great deal of information, and the

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<sup>578</sup> Siobhan Gorman, Annual U.S. Cybercrime Costs Estimated at \$100 Billion, Wall S. J., July 22, 2013 available at <http://online.wsj.com/news/articles/SB10001424127887324328904578621880966242990>

<sup>579</sup> Butler, supra note 575, at 1.

<sup>580</sup> Compare Int'l Ass'n of Machinists & Aerospace Workers v. Werner-Masuda, 390 F. Supp. 2d 479, 499 (D. Md. 2005) (stating that 18 U.S.C. § 2701 is directed against unauthorized users gaining access to protected computers rather than against authorized users gaining access for larcenous acts), with Int'l Airport Ctrs., L.L.C. v. Citrin, 440 F.3d 418, 420 (7th Cir. 2006) (“[18 U.S.C. § 1030] is concerned with ... attacks by virus and worm writers ... from the outside, and attacks by disgruntled programmers.”).

<sup>581</sup> Chris J. Hoofnagle, Identity Theft: Making the Known Unknowns Known, 21 HARV. J.L. & TECH. 97, 107 (2007) (arguing statistics on cybercrime are unconvincing due to victim reluctance on reporting); Bob Tedeschi, E-Commerce Report; Crime is Soaring in Cyberspace, but Many Companies Keep it Quiet, N.Y. TIMES, Jan. 27, 2003, available at <http://www.nytimes.com/2003/01/27/business/e-commerce-report-crime-soaringcyberspacebut-many-companies-keep-it-quiet.html> (identifying loss of consumer confidence as well as “fear of attracting other cyberattacks” and “inviting the ridicule of their competitors” as reasons companies fail to report computer crime).

<sup>582</sup> Joseph M. Olivenbaum, Ctrl-Alt-Delete: Rethinking Federal Computer Crime Legislation, 27 SETON HALL L. REV. 574, 575 n.4 (1997) (arguing the dual system creates doubt in the cybercrime statistics).

<sup>583</sup> Mike McGuire & Santa Dowling, Cyber Crime: A Review of the Evidence Research Report 5 (2013) available at <https://www.gov.uk/government/publications/cyber-crime-a-review-of-the-evidence>.

<sup>584</sup> Ibid.

<sup>585</sup> Marc D. Goodman and Susan W. Brenner, The Emerging Consensus on Criminal Conduct in Cyberspace, 2002 UCLA J. L. & TECH. 3 (2002).

<sup>586</sup> Ibid.

<sup>587</sup> See Economic Crime Survey, supra note 572, at 30 (finding that forty-five percent of financial services organization affected by fraud were also victims of cybercrime, which is three times as much as all other industries).

proceeds of the act often are used to fund fraudulent activity such as terrorism and drug trafficking.<sup>588</sup>

Accordingly, this Chapter will seek to explore the approaches taken by the United States and United Kingdom in their fight against cyber financial crimes. The chapter will first discuss what a cybercrime is and the top forms of cybercrimes along with the tools and infrastructure utilized.<sup>589</sup> Next, the chapter will discuss cyber financial crimes specifically.<sup>590</sup> The development of the laws in the United States<sup>591</sup> and the United Kingdom will then be explored.<sup>592</sup> The chapter will then discuss the problem of cybercrimes and the need for international cooperation and united efforts.<sup>593</sup> The chapter will conclude with a review of what is left to be done in order to combat the threat of cyber financial crimes.<sup>594</sup>

### **What is a Cybercrime?**

There is no common definition to what a cybercrime is.<sup>595</sup> The lack of a common international definition has led to many of the global issues surrounding cybercrimes.<sup>596</sup> However, the unique feature of cybercrimes is that they “are committed across cyber space and do not stop at the conventional state-borders. They can . . . be perpetrated from anywhere and against any computer user in the world.”<sup>597</sup> The internet, as it continues to

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<sup>588</sup> Kimberly Kiefer Peretti, *Data Breaches: What the Underground World of "Carding" Reveals*, 25 Santa Clara Computer & High Tech. L.J. 375 (2009) (discussing the connection between cyber financial crimes and other criminal activity).

<sup>589</sup> See *infra* discussion II.

<sup>590</sup> See *infra* discussion III.

<sup>591</sup> See *infra* discussion IV(A).

<sup>592</sup> See *infra* discussion IV(B).

<sup>593</sup> See *infra* discussion V.

<sup>594</sup> See *infra* discussion VI.

<sup>595</sup> Andrew P. Clark, *Fighting Economic Crime in the Financial Sector*, (PWC 2014) available at [http://www.pwc.com/en\\_GX/gx/economic-crime-survey/pdf/fighting-economic-crime-in-the-financial-services-sector.pdf](http://www.pwc.com/en_GX/gx/economic-crime-survey/pdf/fighting-economic-crime-in-the-financial-services-sector.pdf).

<sup>596</sup> *Ibid.*

<sup>597</sup> Communication from the European Commission to the Council and the European Parliament, *Creating a Safer Information Society By Improving the Security of Information Infrastructures and Combating Computer-Related Crime* 9 (2000), available at <http://europa.eu.int/ISPO/eif/InternetPoliciesSite/Crime/CrimeCommEN.html> [hereinafter *Creating a Safer Information Society*].

develop and progress along with various technological advances, provides the ability for cybercriminals to utilize the internet to perform financial crimes with little chance of fear of repercussions.<sup>598</sup> The internet and technology, by providing a sense of invincibility, also permits experimentation with various criminal endeavours.<sup>599</sup>

“Cybercrime” is a term that is used broadly to refer to the use of a computer to facilitate or carry out a criminal offence.<sup>600</sup> Additionally, the terms “cybercrime,” “computer crime,” “information technology crime,” and high-tech crime” are often used interchangeably and will be used throughout the chapter. However, after several years, there is still no internationally agreed upon definition of the term. This poses problems because law enforcement would have disparities in recognizing what to be sought after and prosecuted, particularly because these crimes can happen anywhere in the world. Disparities exist in defining cybercrimes for several reasons.<sup>601</sup> First, there is not even an agreed upon definition of the term “computer,” which is essential in defining these types of crimes.<sup>602</sup>

In the United States, the legislation passed which focused specifically on computer abuses, the Computer Fraud and Abuse Act of 1984,<sup>603</sup> defined “computer” as “an electronic, magnetic, optical, electrochemical, or other high speed data processing device performing logical, arithmetic, or storage functions, and includes any data storage facility or communications facility directly related to or operating in conjunction with such device, but such term does not include an automated typewriter or typesetter, a portable hand held

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<sup>598</sup> See Conclusions of the Study on Effective Measures to Prevent and Control High-Technology and Computer-Related Crime: Report of the Secretary-General, U.N. Commission on Crime Prevention and Criminal Justice, 10th Sess., Item 4 at 12, U.N. Doc. E/CN.15/2201/4 (2001), available at [http://www.odccp.org/adhoc/crime/10\\_commission/4e.pdf](http://www.odccp.org/adhoc/crime/10_commission/4e.pdf) (concluding that the specific qualities of the Internet may encourage a perpetrator to use it instead of traditional means given it provides great communication facilities and the possibility of concealing one's identity, and the risk of being subjected to criminal investigation, in any of the jurisdictions involved, is relatively low).

<sup>599</sup> See *id.* at 7 (finding the criminal exploitations of new technologies has led to new forms of crimes).

<sup>600</sup> Michael Edmond O'Neil, *Old Crimes in New Bottles: Sanctioning Cybercrime*, 9 GEO. MASON L. REV. 237, 241 (2000).

<sup>601</sup> Rizgar Mohammed Kadir, *The Scope and the Nature of Computer Crimes Statutes: A Critical Comparative Study*, 11:6 GER. L.J. 609, 613 (2010).

<sup>602</sup> *Ibid.*

<sup>603</sup> See Computer Fraud and Abuse Act, 18 U.S.C. § 1030 (2006).

calculator, or other similar device.”<sup>604</sup> This definition is disliked by some computer experts on the basis that it is a limited definition and “fails to recognize the substantial changes in technology that have evolved from main-frame to hand-held computers.”<sup>605</sup> In the United Kingdom, the legislation dedicated to cybercrimes, the Computer Misuse Act of 1990,<sup>606</sup> does not even define “computer.” The Law Commission found that “all the attempted definitions that we have seen are so complex, in an endeavour to be all embracing, that they are likely to produce extensive arguments, and thus confusion for magistrates, juries and judges involved in trying our proposed offences.”<sup>607</sup> The decisions made in the U.S. and U.K. regarding definitions highlight the issues and approaches that many countries take. There are discrepancies in approaches and what qualifies or what type of activity will be prosecuted. However, it is incremental to establish proper definitions of crimes in order to work towards proper legal treatment of the offences.

### **Tools and Infrastructure of Cybercrimes**

Offences dealing with computers may take on various forms and the law must address this characteristic. One criterion to categorize the crime puts the offence in one of two categories. The first category is when the computer is the target of the offence, such as when there is an attack on a network, which is considered as unauthorized access to and illicit tampering with systems, programs, or data.<sup>608</sup> The second category entails traditional offences, such as fraud, theft, or forgery, which are committed with the assistance of or by means of computers, computer networks, or related technologies.<sup>609</sup> Another classification system consists of four categories for cybercrimes: (1) theft of money, financial instruments, property, services, or other valuable data; (2) unauthorized access to computer

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<sup>604</sup> Ibid. § 1030(e).

<sup>605</sup> Carol C. McCall, *Computer Crime Statutes: Are They Bringing the Gap between Law and Technology*, 11 *CRIM. JUSTICE J.* 203, 208 (1989).

<sup>606</sup> *Computer Misuse Act (1990)*, ch. 18.

<sup>607</sup> Steve Shackelford, *Computer-Related Crime: An International Problem in Need of an International Solution*, 27 *Tex. Int'l L.J.* 479 (1992), 491 (citing *The Law Commission, Working Paper No. 186, Criminal Law Computer Misuse 23 (1989)*).

<sup>608</sup> Marc D. Goodman, *Why the Police Don't Care About Computer Crime*, 10 *HARV. J.L. & TECH.*, 465, 468-469 (1997).

<sup>609</sup> Ibid.



time; (3) illegal use of computer programs; and (4) unauthorized acquisition of stored data.<sup>610</sup>

The U.S. Department of Justice (“DOJ”) utilizes a three-category approach in classifying computer crimes, which depend on the computer’s role in the offence.<sup>611</sup> First, the computer may be the “object” of the crime.<sup>612</sup> This category refers to the theft of computer hardware or software, which is generally prosecuted under theft or burglary statutes under state law.<sup>613</sup> Under federal law, the theft of computer hardware may be prosecuted under 18 U.S.C. § 2314, a statute that regulates the interstate transportation of stolen or fraudulently obtained goods.<sup>614</sup> The second category identified is when the computer is the “subject” of the offence.<sup>615</sup> The computer is seen similar to a person who is mugged or a house that is robbed.<sup>616</sup> The computer is the subject for the attack and is the location where any damage occurs.<sup>617</sup> This category includes crimes that may involve malicious software or malware, which includes spam, viruses, worms, Trojan horses, logic bombs, etc. In the past, these crimes were committed typically by juveniles who were not after financial gain.<sup>618</sup> However, recently these crimes have been committed by diverse groups who are seeking a financial gain.<sup>619</sup> These types of malicious software or malware are defined as follows:

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<sup>610</sup> Elizabeth A. Glynn, *Computer Abuse: The Emerging Crime and the Need for Legislation*, 12 *FORDHAM URB. L.J.* 73, 74-75 (1984).

<sup>611</sup> Nat’l Inst. of Justice & Dep’t of Justice, *Computer Crime: Criminal Justice Resource Manual 2* (1989) [hereinafter *DOJ Computer Crime Manual*].

<sup>612</sup> *Ibid.*

<sup>613</sup> *See, e.g., Commonwealth v. Sullivan*, 768 N.E.2d 529, 532 (Mass. 2002) (affirming a burglary conviction for theft of computers).

<sup>614</sup> *See, e.g., United States v. Coviello*, 225 F.3d 54, 62 (1st Cir. 2000) (finding that where a defendant is convicted for conspiracy to transport stolen computer disks in interstate commerce, a sentence enhancement is warranted based on the value of the intellectual property located on the disks).

<sup>615</sup> *See DOJ Computer Crime Manual*, supra note 611, at 2.

<sup>616</sup> Lauren Eisenberg, Tiffany Ho, Rob Boyd, *Computer Crimes*, 50 *AM. CRIM. L. REV.* 681, 684 (2013).

<sup>617</sup> *Ibid.*

<sup>618</sup> *See Reid Skibell, Cybercrimes & Misdemeanors: A Reevaluation of the Computer Fraud and Abuse Act*, 18 *BERKELEY TECH. L.J.* 909, 919-21 (2003).

<sup>619</sup> Cassell Bryan-Low, *Virus for Hire: Growing Number of Hackers Attack Web Sites for Cash-- Entrepreneur Asked a Team to Mastermind Strikes Against Rivals, U.S. Says – WeakKnees on Its Knees*, *WALL ST. J.*, (Nov. 30, 2004) available at <http://online.wsj.com/news/articles/SB110176932097886077> (detailing how hackers have now become a mix of fraudsters and organized crime rings using cybercrimes for financial gain); *see also* Skibell, supra note 618; Bob Sullivan, *Consumers Still Falling for Phish: FTC, DOJ Announce Prosecution of Teen-ager*, *MSNBC*, Mar. 22, 2004, available at <http://www.msnbc.msn.com/id/4580909> (discussing a case of a teenager who utilized a “phishing” scam to steal identities and gain \$78,000).

1. **Spam.** Spam is unsolicited bulk commercial e-mail from a party with no pre-existing business relationship.<sup>620</sup> Spam can also be used by hackers as a means of distributing other malicious software such as viruses and spyware.<sup>621</sup>
2. **Viruses.** Viruses are programs that modify other computer programs.<sup>622</sup> The virus will spread to other computers when a user sends an infected file by e-mail, over the internet, through a company's network or through other forms of sharing.<sup>623</sup>
3. **Worms.** Similar to viruses, worms self-replicate but unlike viruses, worms do not require any action from the computer owner to spread to other computers.<sup>624</sup> Instead, worms are capable of using computer networks to duplicate and transmit itself.<sup>625</sup> Worms can be much more harmful given this ability.<sup>626</sup>
4. **Trojan Horses.** A Trojan horse is a computer program that actually may perform a useful function, but has hidden malicious code to harm the computer.<sup>627</sup> The code that is transmitted into the computer may contain a virus or other kind of bug or it may permit unauthorized access by an outside user.<sup>628</sup>
5. **Logic bombs.** Logic bombs are computer programs that initiate at a certain time and under specified conditions.<sup>629</sup> The commands given to the computer may be benign or damaging. They can also go undetected in software or hardware

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<sup>620</sup> Matthew B. Prince & Patrick A. Shea, *After CAN-SPAM, How States Can Stay Relevant in the Fight Against Unwanted Messages: How a Children's Protection Registry Can be Effective, and Is Not Preempted, Under the New Federal Anti-Spam Law*, 22 J. MARSHALL J. COMPUTER & INFO. L. 29, 45 (2003).

<sup>621</sup> S. Rep. No. 108-102, at 6 (2003).

<sup>622</sup> Neal Kumar Katyal, *Criminal Law in Cyberspace*, 149 U. PA. L. REV. 1003, 1023 (2001).

<sup>623</sup> *Ibid.* at 1024.

<sup>624</sup> *Ibid.*

<sup>625</sup> *Ibid.*

<sup>626</sup> *Ibid.*

<sup>627</sup> *Ibid.*

<sup>628</sup> *Ibid.*

<sup>629</sup> *Ibid.*

until it is ready to be set off.<sup>630</sup> It is a powerful crime tool as software programs can be infected with a bomb and millions of copies could be sold.<sup>631</sup>

**6. Sniffers.** Sniffers enable a person to read data as it travels through a network. Hackers often use this tool after hacking into a network in order to log all the activity on the network.<sup>632</sup> The information a hacker can obtain from a sniffer includes, passwords, credit card numbers, and other personal information.

**7. Botnets.** Botnets have become a major threat when it comes to cybercrimes.<sup>633</sup> This threat consists of groups of individual computers that are infected with malware, which turns the infected computers into “robots.”<sup>634</sup> This enables cyber criminals to control the computer remotely without the owner’s knowledge from command and control servers.<sup>635</sup> The malware used on the computers may also scan for further vulnerabilities in the system, allowing for the launch of further attacks.<sup>636</sup>

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The third category according to the U.S. DOJ is when the computer is the “instrument” used to commit a traditional crime.<sup>637</sup> Traditional crimes include identity

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<sup>630</sup> Ibid.

<sup>631</sup> Ibid.

<sup>632</sup> Troy Denkinger, The Basics of Sniffing, The Sysadmin's Eye Inside the Network, CHI. TRIB., (Apr. 6, 2000), available at [http://articles.chicagotribune.com/2000-04-06/news/0005260051\\_1\\_configuration-ethernet-local-area-network](http://articles.chicagotribune.com/2000-04-06/news/0005260051_1_configuration-ethernet-local-area-network).

<sup>633</sup> See Criminal Money Flows on the Internet: Methods, Trends and Multi-Stakeholder Counteraction, Money Val 17 (2012) available at [http://www.coe.int/t/dghl/monitoring/moneyval/typologies/MONEYVAL\(2010\)9\\_Reptyp\\_full\\_en.pdf](http://www.coe.int/t/dghl/monitoring/moneyval/typologies/MONEYVAL(2010)9_Reptyp_full_en.pdf) [hereinafter, Criminal Money Flows].

<sup>634</sup> Ibid.

<sup>635</sup> Ibid.

<sup>636</sup> Ibid. (noting that spam or distributed denial of service, DDOS, attacks are often launched to shutdown critical infrastructure of businesses).

<sup>637</sup> DOJ Computer Crime Manual, supra note 611, at 2.

theft,<sup>638</sup> distribution of child pornography,<sup>639</sup> copyright infringement,<sup>640</sup> and mail or wire fraud.<sup>641</sup>

### **Cyber Financial Crimes**

In today's market, businesses and entities at all levels feel the need to maintain an online presence in order to succeed.<sup>642</sup> The financial sector in particular took advantage of information and communication technology early on so that they could prepare the ground for borderless, around the clock global trading and offering of services.<sup>643</sup> As a consequence, however, cyber financial crimes have become the world's third corporate-risk priority overall.<sup>644</sup> Financial services are the main targets for cyber criminals, and often fall victim to large data breaches which compromises personal financial information, such as credit or debit card account information, rather than other types of personally identifiable information, such as Social Security numbers.<sup>645</sup>

Cyber financial crimes are usually initiated in the underground economies<sup>646</sup> that have developed on the internet.<sup>647</sup> These underground economies have become essential to the infrastructure of cybercrimes.<sup>648</sup> They provide malicious codes and tools for committing the crimes and aid in the development of the malware.<sup>649</sup> Criminals also use

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<sup>638</sup> See, e.g., *United States v. Prochner*, 417 F.3d 54, 57 (1st Cir. 2005) (affirming a conviction for a defendant who obtained credit card numbers by hacking into secure websites and computer networks).

<sup>639</sup> See, e.g., *United States v. Brown*, 237 F.3d 625, 628-29 (6th Cir. 2001) (affirming sentence because of computer use in violating non-computer-dependent child pornography statute).

<sup>640</sup> See, e.g., *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913 (2005) (holding software distributors who promote the software's use to infringe copyright liable for the infringement carried out by third parties using the software, despite the fact that the software has other lawful uses).

<sup>641</sup> See, e.g., *United States v. Pirello*, 255 F.3d 728, 729 (9th Cir. 2001) (affirming sentence for violation of federal wire fraud statute where defendant posted a fraudulent solicitation for money on a classified ad website).

<sup>642</sup> *Financial Crimes: A Threat to Global Financial Crimes: A Threat to Global Security* 121 (Maximilian Edelbacher et al. 2012)

<sup>643</sup> *Ibid.*

<sup>644</sup> See Bhat & Threattil, *supra* note 574, at 1.

<sup>645</sup> See Peretti, *supra* note 588, at 378.

<sup>646</sup> See *Financial Crimes*, *supra* note 642, at 127 (defining underground economy as involving an exchange of goods and services that are concealed from official view).

<sup>647</sup> See *Financial Crimes* *supra* note 642, at 127.

<sup>648</sup> *Ibid.*

<sup>649</sup> *Ibid.*

these underground economies to assist with sharing techniques to avoid detection.<sup>650</sup> Hence, the underground economy forms a market for stolen goods, especially for credit card or bank account details and other personal information that is useful for identity theft and fraud.<sup>651</sup> Thus, the underground market has become an environment in cyberspace where cyber criminals can organize, sell goods and services and share proceeds from the crimes they commit.<sup>652</sup>

Once a financial cybercrime has been committed, the criminals must be able to transfer the proceeds online without revealing or leaving traces of their own identity.<sup>653</sup> This can often be the most difficult part of a financial cybercrime.<sup>654</sup> The common way cyber criminals go about this step is through the use of “money mules” or “financial agents” who set-up bank accounts or make their own accounts available for transfers of earnings. Once the money mule has received the funds, further instructions are given to them to transfer the money to other accounts or send the money overseas via wire transfer.<sup>655</sup> In utilizing the types of malware and malicious programs discussed above, cyber criminals can perform a number of financial fraud crimes on victims.

Some of the most common types of fraud involved in cyber financial crimes include payment card fraud, account takeover and even traditional crimes such as money laundering have now turned to cyberspace. Payment card fraud is a multi-billion dollar problem domestically and globally.<sup>656</sup> Although the numbers on the actual cost of payment fraud is not known, one study estimated total costs of credit and debit card fraud in the U.S. at approximately \$109 billion in 2008.<sup>657</sup> Merchants in the United States in 2013 are also

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<sup>650</sup> Ibid.

<sup>651</sup> Ibid.

<sup>652</sup> Ibid.

<sup>653</sup> Ibid.

<sup>654</sup> Ibid.

<sup>655</sup> Ibid.

<sup>656</sup> Adam J. Levitin, *Private Disordering? Payment Card Fraud Liability Rules*, 5 *BROOK. J. CORP. FIN. & COM. L.* 1, 2 (2010).

<sup>657</sup> See LexisNexis, *2009 LexisNexis True Costs of Fraud Study* 6, 50, 54 (2009), available at [http://www.riskfinance.com/RFL/Merchant\\_Card\\_Fraud\\_files/LexisNexisTotalCostFraud\\_09.pdf](http://www.riskfinance.com/RFL/Merchant_Card_Fraud_files/LexisNexisTotalCostFraud_09.pdf)

paying \$2.79 for each dollar of fraud losses, an increase from the previous year.<sup>658</sup> The most common form of payment card fraud involves card-not-present payments.<sup>659</sup> These transactions are often done over the internet, phone, or mail.<sup>660</sup> In 2013, the United Kingdom experienced a twenty-two percent increase in losses based card-not-present transactions.<sup>661</sup> This type of cyber financial crimes is also on the rise in the United States.<sup>662</sup> Although fraud prevention techniques have helped, many criminals turn to technological advances to carry out the payment card fraud.<sup>663</sup> Cyber criminals collect debit or credit card information that is put in by the consumer making a transaction and later use this information for their own benefit.<sup>664</sup> Additionally, cyber criminals can use stolen card data and create a counterfeit card.<sup>665</sup> Another form of payment card fraud consists of when criminals simply use fake data to create a fake card.<sup>666</sup>

Account takeovers are one form of identity theft.<sup>667</sup> This occurs when someone other than the authorized account owner gains access to an existing account.<sup>668</sup> The ultimate goal of an account takeover is to steal, procure, or otherwise affect funds of the targeted account.<sup>669</sup> Hackers use malware to hack into computer networks to steal online banking credentials, allowing the cyber criminals to make payments, transfer money, or apply for new accounts.<sup>670</sup> The use of malware to collect banking credentials is on the rise

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<sup>658</sup> See LexisNexis, 2013 LexisNexis True Costs of Fraud Study 9 (2013) available at <http://www.lexisnexis.com/risk/downloads/assets/true-cost-fraud-2013.pdf> [hereinafter LexisNexis 2013 Study].

<sup>659</sup> See Financial Crimes, supra note 642, at 134.

<sup>660</sup> See Levitin, supra note 656, at 19.

<sup>661</sup> News Release, Scams and Computer Attacks Contribute to Increase in Fraud, as Total Card Spending Rises, Financial Fraud Action UK (Mar. 14, 2014) available at <http://www.financialfraudaction.org.uk/cms/assets/1/2013%20annual%20fraud%20figures%20release%20-%20final.pdf>.

<sup>662</sup> See LexisNexis 2013 Study, supra note 658, at 17 (determining that card not present crimes initiated online have increased by thirty-six percent).

<sup>663</sup> See *id.* (finding that criminals are increasingly using malware to perform financial crimes).

<sup>664</sup> See generally, Levitin, supra note 656, at 10-15 (explaining the process of payment card fraud).

<sup>665</sup> See *Ibid.* at 19.

<sup>666</sup> *Ibid.*

<sup>667</sup> Lilia Rode, Database Security Breach Notification Statutes: Does Placing the Responsibility on the True Victim Increase Data Security? 43 HOUS. L. REV. 1597, 1624 (2007).

<sup>668</sup> Michael Castell. Mitigating. Online Account Takeovers. The Case Education, Federal Reserve Bank of Atlanta (2013) available at [https://www.frbatlanta.org/documents/rprf/rprf\\_pubs/130408\\_survey\\_paper.pdf](https://www.frbatlanta.org/documents/rprf/rprf_pubs/130408_survey_paper.pdf).

<sup>669</sup> *Ibid.*

<sup>670</sup> See Financial Crimes. ,supra note 642, at 135.

which leads to more data breaches resulting in greater cyber financial crimes.<sup>671</sup> Corporate account takeovers have become an even bigger threat to financial institutions and other business.<sup>672</sup> Cyber criminals would hack into businesses accounts and obtain sensitive information and transfer funds.<sup>673</sup> Financial institutions and business have become major targets for cyber financial crimes considering the large amount of customer and personal financial data held on networks, as well as the fact that those institutions are where the money is.<sup>674</sup> Although larger institutions are more apt to detect the breach, many do not know when they have suffered a cyber financial crime until after the fact.<sup>675</sup>

Increasingly, cyberspace has become the domain for money laundering, or the act turning dirty money into clean money as well.<sup>676</sup> Criminal organizations have begun to take advantage of how dependent society has become on the Internet to launder their illegally acquired proceeds through covert, anonymous online transactions.<sup>677</sup> Money launders are able to benefit from the development of technology because as online marketplaces become more robust and complex their activity is more untraceable.<sup>678</sup> The criminals are able to find new methods to pass the “dirty” money into online accounts and retrieve the “clean” money out of other accounts.<sup>679</sup> When these criminals have obtained credit card or bank account information, they simply search for means to transfer the money anonymously, through services such as Liberty Reserve.<sup>680</sup>

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<sup>671</sup> See LexisNexis 2013 Study, *supra* note 658, at 16.

<sup>672</sup> Tommie Singleton, *The Top Five Cyber Crimes*, AICPA 1 (2013).

<sup>673</sup> *Ibid.* at 7.

<sup>674</sup> See *Economic Crime Survey*, *supra* note 572, at 30.

<sup>675</sup> *Ibid.*

<sup>676</sup> See *The Secrets of Online Money Laundering*, MIT TECH. R., Oct. 18, 2013, available at <http://www.technologyreview.com/view/520501/the-secrets-of-online-money-laundering/>.

<sup>677</sup> See Jean-Loup Richet, *Laundering Money Online: A Review of Cybercriminals' Methods*, UNODC, June 1, 2013, available at <http://arxiv.org/ftp/arxiv/papers/1310/1310.2368.pdf> (identifying online gaming and micro laundering as two areas in cyberspace to facilitate money laundering); see also *Criminal Money Flows*, *supra* note 633, at 21 (discussing that terrorist also use these methods to raise funds and transfer the money).

<sup>678</sup> *Ibid.*

<sup>679</sup> *Ibid.*

<sup>680</sup> *Ibid.* (describing that Liberty Reserve is an online service to exchange money anonymously that was shut down by the U.S. Government); see also Alexis C. Madrigal, *How to Launder Billions and Billions of Digital Dollars*, ATLANTIC, Nov. 4, 2013, available at <http://www.theatlantic.com/technology/archive/2013/11/how-to-launder-billions-and-billions-of-digital-dollars/281091/> (“Liberty Reserve created a digital currency, LR credits. People could open an account with Liberty Reserve and then store their money in the form of these credits. When they wanted to get

Launderers also take advantage of mass media and email scams.<sup>681</sup> They may attempt to steal money from the victim's account or they may transfer large sums of illegal money into the victim's account.<sup>682</sup> Money launderers also take advantage of the benefits of anonymity of cyberspace by transferring the money globally to areas of the world where regulation is the weakest.<sup>683</sup> The ability for cyber criminals to achieve their objectives undetected highlights the challenge of cyber financial crimes. Many institutions do not know who the threat is, where it comes from or if it even happened.<sup>684</sup>

### **Development of the Laws**

The technologies that computers and cyberspace have provided are unique and are capable of addressing many of the world's problems. At the same time, however, these technologies also have a dark side.<sup>685</sup> Cybercrime is not only an increasing threat, but its potential for harm may be far greater than in traditional criminal enterprises.<sup>686</sup> The development of personal computers, Smartphone, tablets and the like pose a significant concern for law enforcement.<sup>687</sup> These devices possess the ability to access the internet virtually anywhere with the capacity to send information and potential criminal activity quickly and efficiently.<sup>688</sup> The result of such action is that police or law enforcement agencies have significantly less time to react to potential cybercrime threats.<sup>689</sup>

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money in or out, they couldn't just send a wire or go to an ATM. Instead, Liberty Reserve contracted with other companies they controlled known as "exchangers" which bought and sold regular money in exchange for LR credits").

<sup>681</sup> Ibid.

<sup>682</sup> Ibid. (finding that if the money is transferred to the victim, the criminals will have that money transferred again to an alias account).

<sup>683</sup> Madrigal, supra note 680.

<sup>684</sup> See Ibid. (discussing the problem with lack of knowledge is also the lack of reporting); see also McGuire & Dowling, supra note 583, at 20 (commenting that there is little evidence regarding cyber criminals).

<sup>685</sup> Goodman & Brenner, supra note 585, at 7

<sup>686</sup> O'Neil, supra note 600, at 238.

<sup>687</sup> Katyal, supra note 622, at 1042 (arguing that the rule of law is threatened by computers and cyberspace because (1) computers are a powerful alternative for additional people in a criminal enterprise; (2) computers allow anonymity and secure communications; and (3) cybercriminals are often invisible, remote, and untraceable.)

<sup>688</sup> Goodman & Brenner, supra note 585, at 8.

<sup>689</sup> Ibid.



Additionally, issues of jurisdiction, privacy and anonymity arise making the fight against cyber financial crimes increasingly difficult.<sup>690</sup>

Furthermore, the ability of cybercrimes to develop and change into new forms of criminal behaviour and therefore avoiding the reach of existing criminal law creates even more challenges for law enforcement around the globe. Cybercriminals are able to exploit loopholes in their own country's criminal law to victimize their fellow citizens with impunity.<sup>691</sup> They also have been able exploit the loopholes in the criminal laws of other countries to victimize the citizens of those and other nations, demonstrating just how universal the situation of cyber financial crimes has become.<sup>692</sup> Thus, the relationship between technology and the law is one that is continuously evolving and in which innovations benefit consumers but also provide a new realm for criminals.<sup>693</sup>

Every country continues to struggle to define computer crimes and develop computer crime legislation applicable to both domestic and international audiences.<sup>694</sup> Solutions that only apply domestically are thought to be inadequate considering cyberspace has no physical or political borders,<sup>695</sup> but also because many computer networks are effortlessly and covertly accessed from anywhere in the world.<sup>696</sup> Accordingly, there are some commentators who have argued that cyberspace differs so dramatically from real crimes and that cybercrimes demand a change in the way countries think about the

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<sup>690</sup> Ibid.

<sup>691</sup> See, e.g., U.S. Department of Justice, 1999 Report on Cyberstalking: A New Challenge for Law Enforcement and Industry, <http://www.usdoj.gov:80/criminal/cybercrime/cyberstalking.htm>.

<sup>692</sup> See Frances Ann Burns, Hack Attack Shuts Down Online Auction Site, *apbnews.com* (Sept. 12, 2000), [http://www.apb.com/newscenter/breakingnews/2000/09/12/bidbay0912\\_01.html](http://www.apb.com/newscenter/breakingnews/2000/09/12/bidbay0912_01.html).

<sup>693</sup> O'Neil, *supra* note 600, at 240.

<sup>694</sup> See generally Kate Reder, *Ashcroft v. ACLU: Should Congress Try, Try, and Try Again, or Does the International Problem of Regulating Internet Pornography Require an International Solution?* 6 N.C. J. L. & TECH. 139 (2004); Press Release, U.S. Dep't of Justice, U.S. Department of Justice Promotes International Network to Combat Intellectual Property Crime (Mar. 9, 2011), *available at* <http://www.justice.gov/opa/pr/2009/March/09-crm-217.html>.

<sup>695</sup> See *Reno v. ACLU*, 521 U.S. 844, 851 (1997) (defining cyberspace as a "unique medium ... located in no particular geographical location but available to anyone, anywhere in the world, with access to the Internet").

<sup>696</sup> Walter Gary Sharp, Sr., Note, *Redefining National Security in Today's World of Information Technology and Emergent Threats*, 9 DUKE J. COMP. & INT'L L. 383, 384 (1999); see also Steve Shackelford, Note, *Computer-Related Crime: An International Problem in Need of an International Solution*, 27 TEX. INT'L L.J. 479, 494 (1992).

application of traditional legal doctrines.<sup>697</sup> Both the United States and United Kingdom have taken an approach of creating separate codes dealing specifically with computer crimes.<sup>698</sup>

During the initial attempt to handle computer systems and their ability to collect, store and transmit data, many of the western countries developed legislation aimed at protecting privacy.<sup>699</sup> In the 1980s, as computer technology and the laws continued to develop, economic crimes began to be embodied in the legislation.<sup>700</sup> This wave of legislation was triggered due to the inadequacy of existing criminal codes, which dealt with traditional crimes and were established to protect physical, tangible and visible objects only.<sup>701</sup> The new laws which emerged addressed the new capabilities of computer related crimes to violate traditional objects through new means,<sup>702</sup> to involve intangible objects,<sup>703</sup> and to utilize new approaches of committing crimes made possible by increasing use and reliance on computer systems and networks.

### **Cybercrime Laws in the United States**

As noted above, the United States Congress decided to treat cybercrimes as separate and distinct federal offences rather than amending existing criminal law to incorporate the technological changes. The scope of the federal law that addresses cybercrimes has thus expanded overtime in an attempt to keep up with the digital age.<sup>704</sup> The principal statute

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<sup>697</sup> Niva Elkin-Koren & Eli M. Salzberger, *Law and Economics in Cyberspace*, 19 INT'L REV. L. & ECON. 553 (1993); but see Easterbrook, *Cyberspace and the Law of the Horse*, 1996 U. CHI. LEGAL F. 207, 207-16.

<sup>698</sup> See Kadir, *supra* note 602, at 625 (finding that this approach has been viewed as beneficial because it creates awareness of cybercrimes which has been considered a means of deterring).

<sup>699</sup> Ulrick Sieber, *Legal Aspects of Computer-Related Crime in the Information Society*, COMCRIME Study prepared for the European Commission 19 (Jan. 1998), available at <http://europa.eu.int/ISPO/legal/en/comcrime/sieber.doc>.

<sup>700</sup> *Ibid.*

<sup>701</sup> *Ibid.*

<sup>702</sup> For example, stealing money by taking over or misusing bank accounts. See *id.*

<sup>703</sup> This would be done with the use of computer programs.

<sup>704</sup> Deborah F. Buckman, *Validity, Construction, and Application of Computer Fraud and Abuse Act*, 174 A.L.R. Fed. 101 (2001). But see Maxim May, *Federal Computer Crime Laws*, SANS Inst. 1 (2004) available at <http://www.sans.org/reading-room/whitepapers/legal/federal-computer-crime-laws-1446> (“[L]aws that take into account the new and constantly evolving technologies are always lagging behind the criminals who make use of these technologies”).

which handles cybercrimes was enacted in 1984 as the Counterfeit Access Device and Computer Fraud and Abuse Law,<sup>705</sup> now more commonly referred to as the Computer Fraud and Abuse Act (“CFAA”).<sup>706</sup> The statute enumerates various crimes which involve “protected computers.”<sup>707</sup> The CFAA imposes both civil and criminal liability on cybercriminals who partake in internet attacks on corporations and the government.<sup>708</sup> Although the original 1984 statute was intended to combat cybercrimes, it dealt specifically with unauthorized access to federal interest computers, thus leaving loopholes in the legislation.<sup>709</sup> The manner in which the statute was designed made it very difficult to prosecute cybercriminals.<sup>710</sup> In 1986, the Act was amended to include computer fraud and hacking offences.<sup>711</sup> However, the jurisdiction of the Federal government was left only when there was a compelling federal interest.<sup>712</sup>

In 1994, another set of amendments changed the Act. Section 1030(a)(5), was amended "to further protect computers and computer systems covered by the statute from damage both by outsiders, who gain access to a computer without authorization, and by insiders, who intentionally damage a computer."<sup>713</sup> Additionally, subsection 1030(a)(5)(A) specifically prohibits "knowingly [causing] the transmission of a program, information, code, or command" which "intentionally causes damage without authorization....." This change was done in order to address the threat of malware and malicious codes that were discussed above.<sup>714</sup> The focus of the Act then shifted towards the defendant’s harmful intentions and the resulting damage, rather than a technical concept of computer access and

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<sup>705</sup> Pub. L. No. 98–473, 98 Stat. 2190.

<sup>706</sup> 18 U.S.C.A. § 1030 (2006 & Supp. 2008).

<sup>707</sup> 18 U.S.C. § 1030(e)(2) (defining “protected computer” as any computer that a financial institution or the United States Government uses, computers whose damage affects government interest or financial intuitions, or computers that are used in interstate or foreign commerce or communication).

<sup>708</sup> 18 U.S.C.A. § 1030.

<sup>709</sup> See Buckman, *supra* note 704, at § 2(a) (discussing that the loopholes included authorized persons who caused harm to protected computer systems; or unauthorized persons who gave codes or software to authorized persons who loaded them into their computers).

<sup>710</sup> See D. Glenn Baker, *Trespassers Will be Prosecuted: Computer Crime in the 1990's*, 12:1 *Computer L.J.* 68 (1993) (noting only one indictment was made under the original 1984 Act).

<sup>711</sup> Skibell, *supra* note 618, at 913.

<sup>712</sup> See Buckman, *supra* note 704, at § 2(a).

<sup>713</sup> See S. Rep. No. 104–357, § IV(1)(E) (1996 W.L. 492169); H.R. Conf. Rep. No. 103–711, § 290001(d) (1994 W.L. 454841), 1994 U.S.C.C.A.N. 1839.

<sup>714</sup> See May, *supra* note 704, at 3.

authorization.<sup>715</sup> However, this shift also resulted in a change of the mens rea for the new offences to be “intentionally” rather than “knowingly,” the less burdensome demonstration of culpability.<sup>716</sup> The 1996 amendments again changed the mens rea requirements of the CFAA, creating essentially two felonies and a misdemeanour, which were to cover a variety of crimes.<sup>717</sup>

The first felony involved intentional acts of damaging a computer by knowingly transmitting harmful programs.<sup>718</sup> The second felony applied to those who intentionally accessed a computer without authorization and negligently causing harm.<sup>719</sup> As a consequence of broadening the mens rea requirements for the offences, the amendments significantly expanded the reach of the Act.<sup>720</sup>

Currently, the CFAA criminalizes seven types of computer offences. The first is the transmission of classified government information.<sup>721</sup> This prohibits a criminal from knowingly accessing a computer without or in excess of authorization and who transmits government information which is classified.<sup>722</sup> The second offence is when information is obtained from a financial institution, the federal government, or any protected computer through unauthorized or in excess of authorization computer access.<sup>723</sup> The third occurs when an offender without or in excess of authorization access any non-public computer of a U.S. department or agency without authorization.<sup>724</sup> The fourth offence covers unauthorized or in excess of authorization access for the intent to defraud and obtain anything of value.<sup>725</sup> The fifth offence is when damage is done to a protected computer as

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<sup>715</sup> See 139 Cong. Rec. S16421-03, Nov. 19, 1993

<sup>716</sup> Skibell, *supra* note 618, at 913.

<sup>717</sup> *Ibid.*

<sup>718</sup> *Ibid.*

<sup>719</sup> *Ibid.*

<sup>720</sup> *Ibid.* See also See S. Rep. No. 104-357, at 9-12 (demonstrating that Congress wanted to also punish hackers who do not intentionally cause damage to computers).

<sup>721</sup> 18 U.S.C. § 1030(a)(1).

<sup>722</sup> *Ibid.* Given the 1996 amendments, the offender does not need to know or believe that the information will be used to injure the United States; it is sufficient if the information could be used to harm the U.S.

<sup>723</sup> *Ibid.* at § 1030(a)(2). “Obtaining” includes merely reading the information.

<sup>724</sup> *Ibid.* at § 1030(a)(3).

<sup>725</sup> *Ibid.* at § 1030(a)(4). The mere “use” of the computer may qualify as a thing of value, but if so, the value of that use must exceed \$5,000 in a one-year period. The four elements to this offence are: 1) “knowingly” with intent to defraud; 2) accessing a protected computer; 3) “without authorization” or “exceeding authorization;” and 4) furthering a fraud or obtaining anything of value.

a result of access without or in excess of authorization.<sup>726</sup> The transmission of a malicious program may be prosecuted under this section regardless if damage was caused intentionally, recklessly, or otherwise.<sup>727</sup> Additionally, under the fifth offence, an offender is culpable when they intentionally access a protected computer without authorization that recklessly causes damage to a protected computer.<sup>728</sup> Password theft and online extortion are covered by the last two offences.<sup>729</sup>

The CFAA in litigation has encountered several disputes and debates in an attempt to define the scope of a user's authorization when the perpetrator uses a computer to damage information or uses it without or in excess of authority.<sup>730</sup> *Morris v. United States* was the first case to discuss the scope of authorization under the CFAA.<sup>731</sup> Morris was a graduate student who created a worm designed to exploit vulnerabilities in certain programs and the internet.<sup>732</sup> Morris managed to access several Ivy League universities networks, but once he released the worm it quickly spread across the United States.<sup>733</sup> Morris was convicted and made an unsuccessful appeal claiming he had not intended to cause the amount of damage that was required by the CFAA.<sup>734</sup> In the appeal, the Second Circuit developed the Intended Function Test as a means to determine when access is unauthorized.<sup>735</sup> The Second Circuit found that unauthorized access happens when a defendant does not use the attacked program or network "in any way related to their intended function."<sup>736</sup> In 2007, the Fifth Circuit adopted the Intended Function test in *United States v. Phillips*.<sup>737</sup> The Fifth Circuit held that analysis of these cases begins with "the scope of a user's authorization to access a protected computer on the basis of the

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<sup>726</sup> Ibid. at § 1030(a)(5).

<sup>727</sup> Ibid. § 1030(a)(5)(A) Offenders with authorized access to a system, also known as insiders, are culpable under this section of the statute only if they intentionally cause harm.

<sup>728</sup> Ibid. at § 1030(a)(5)(B).

<sup>729</sup> Ibid. at § 1030(a)(6), (7).

<sup>730</sup> W. Cagney McCormick, *The Computer Fraud & Abuse Act: Failing to Evolve with the Digital Age*, 16 *SMU SCI. & TECH. L. REV.* 481, 499 (2013).

<sup>731</sup> See *Morris v. United States*, 928 F.2d 504, 510 (2d Cir. 1991).

<sup>732</sup> Ibid.

<sup>733</sup> Ibid.

<sup>734</sup> Ibid.

<sup>735</sup> Ibid.

<sup>736</sup> Ibid.

<sup>737</sup> *United States v. Phillips*, 477 F.3d 215, 219 (5th Cir. 2007).

expected norms of intended use or the nature of the relationship established between the computer owner and the user.”<sup>738</sup>

The circuit courts are split on how to determine the scope of exceeded authorized access, particularly when there is no limit on authorization.<sup>739</sup> The majority follows the Intended Function test and has held that access exceeds authorization “when the user knows or reasonably should know that he or she is not authorized to access a computer and information obtainable from that access in furtherance of or to perpetrate a crime.”<sup>740</sup> The minority view holds that an employee who has authority to access the employer’s computer does not violate the CFAA when the employee uses his privilege for the misappropriation of accessed information.<sup>741</sup> The minority has articulated that “an interpretation of the CFAA based upon agency principles would greatly expand the reach of the CFAA to any employee who accesses a company's computer system in a manner that is adverse to her employer's interests.”<sup>742</sup>

Despite the inconsistencies between circuit courts on the reach of the CFAA, neither the Supreme Court nor Congress has taken a stance to quiet the debate.

### **Cybercrime Laws in the United Kingdom**

The United Kingdom currently has one of the world’s largest internet-based economies.<sup>743</sup> Accordingly, the U.K. government has found cyber security to be one of its top four risks.<sup>744</sup> Similar to the United States, the U.K. has enacted a separate legislation to

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<sup>738</sup> Ibid.

<sup>739</sup> McCormick, *supra* note 730, at 492.

<sup>740</sup> United States v. John, 597 F.3d 263, 271 (5th Cir. 2010).

<sup>741</sup> LVRC Holdings LLC v. Brekka, 581 F.3d 1127, 1135 (9th Cir. 2009).

<sup>742</sup> United States v. Aleynikov, 737 F. Supp. 2d 173, 194 (S.D.N.Y. 2010).

<sup>743</sup> The UK Cyber Security Strategy: Landscape Review, Nat’l Audit Office 5 (2013) *available at* <http://www.nao.org.uk/wp-content/uploads/2013/03/Cyber-security-Full-report.pdf> [hereinafter UK Cyber Security Strategy] (finding the U.K.’s internet economy to be valued at £121 billion in 2010).

<sup>744</sup> Ibid.

deal with computer crimes. The cornerstone of the United Kingdom's cybercrime legislation is the Computer Misuse Act of 1990 ("CMA").<sup>745</sup>

The purpose of the CMA was to protect the integrity and security of computer systems, rather than the information stored on the computer.<sup>746</sup> This is because the United Kingdom does not use criminal law as a basis for protecting privacy.<sup>747</sup> The CMA was thus initially questioned since some of the offences deal with unauthorized access of information.<sup>748</sup> Furthermore, although hacking has been also compared to trespassing, many in the U.K. could still not understand the purpose of the CMA criminalizing the offences since trespassing was nothing more than a tort and therefore a civil offence.<sup>749</sup> Thus, the idea of "information theft" as a criminal offence has continuously been debated since the introduction of the CMA.<sup>750</sup> Nevertheless, the genuine legal concerns which brought the CMA into action existed and the Law Commission continued to press for better strategies.<sup>751</sup>

The Computer Misuse Act had its beginnings in 1987 when the Scottish Law Commission recommended that hacking should only be criminalized when the offender intended to commit further acts.<sup>752</sup> In 1989, the English Law Commission recommended that hacking be criminalized regardless of further intent.<sup>753</sup> However, in 1988, the case of *R v. Gold* was decided by the House of Lords and highlighted the need for legislative action.<sup>754</sup> The case involved two defendants who obtained a password, which provided them, unauthorized access to British Telecom's Prestel network.<sup>755</sup> The hackers made

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<sup>745</sup> Computer Misuse Act 1990 (c. 18) (Eng.).

<sup>746</sup> Law Com. No.186, Computer Misuse. Cm.819 (1989), para.2.13 ("[T]he case for a criminal offence of basic hacking does not turn on the need to protect information").

<sup>747</sup> See Neil MacEwan, *The Computer Misuse Act 1990: Lessons from its Past and Prediction for its Future*, 12 Crim. L. Rev. 955, 956 (2008) available at [http://usir.salford.ac.uk/15815/7/MacEwan\\_Crim\\_LR.pdf](http://usir.salford.ac.uk/15815/7/MacEwan_Crim_LR.pdf).

<sup>748</sup> Ibid.

<sup>749</sup> Ibid.

<sup>750</sup> Ibid.

<sup>751</sup> Ibid. (noting that the CMA was the compromise between radical thought and minimal action).

<sup>752</sup> Sc. Law Com. No. 106 (1987).

<sup>753</sup> Law Com. No. 186 (1989).

<sup>754</sup> (1988) 1 AC 1063.

<sup>755</sup> Ibid.

extensive use of the system but were soon arrested when suspicion grew over their conduct.<sup>756</sup> The question then arose as to what offence the two should be charged with.<sup>757</sup> There was no deception upon a human mind so the defendants could not be charged under s. 15 of the Theft Act of 1968.<sup>758</sup> Instead, the defendants were prosecuted under s. 1 of the Forgery and Counterfeiting Act of 1981.<sup>759</sup> The Court of Appeals and House of Lords overturned the convictions however.<sup>760</sup> Thus began the demand for legislative efforts and the CMA was constructed.<sup>761</sup>

The CMA created three new offences. Under § 1 of the Act, an offender can be criminalized if they access programs or data on a computer without authorization.<sup>762</sup> This is regardless of whether the intent was to access specific data or program.<sup>763</sup> Section 2 provides that once there has been unauthorized access, an offender who intentionally attempts to commit a certain acts or facilitates the commission of certain acts is guilty and punishable by imprisonment for up to five years.<sup>764</sup> Under § 2, it does not matter whether the attempted act was impossible or the offender attempted an act a different or later time than the unauthorized access.<sup>765</sup> Section 3 addresses unauthorized impairment of information or content on any computer, so long as the offender possessed the required mens rea.<sup>766</sup> To fall under this section, the offender would need to act with intent or recklessness to impair the operation of computer, prevent or hinder access to any data or program on the computer, impair the operation of any data or programs on the computer, or enable any of the acts just mentioned.<sup>767</sup> For purposes of this section, it is irrelevant

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<sup>756</sup> Ibid.

<sup>757</sup> Ibid.

<sup>758</sup> Charles Wild Et, *AI Electronic and Mobile Commerce Law: Analysis of Trade, Finance Media and Cybercrime in the Digital Age* 362 (2011).

<sup>759</sup> Ibid. at 363 (explaining forgery is found when a person makes a false instrument with the intention of inducing another into accepting it as genuine).

<sup>760</sup> Ibid.

<sup>761</sup> Ibid.

<sup>762</sup> Computer Misuse Act 1990 c. 18, § 1.

<sup>763</sup> Ibid.

<sup>764</sup> Ibid. at § 2. Further offences would include any for which the sentence is fixed by law or one in which a person over the age of twenty-one would be sentenced to imprisonment for five years.

<sup>765</sup> Ibid. at § 2(3), 4.

<sup>766</sup> Ibid. at § 3.

<sup>767</sup> Ibid.



whether the offender directed the impairment at any particular computer, program, or data, or that any particular kind of modification was intended.<sup>768</sup>

In 2006, the Police and Justice Act (“PJA”) amended the CMA.<sup>769</sup> Section 35 of the PJA increased the penalty for §1 offence.<sup>770</sup> The offence of unauthorized access became indictable and the maximum imprisonment period increased from six months to twelve months on summary convictions or two years on conviction from indictment.<sup>771</sup> The amendment acknowledges the global nature and seriousness of the offence and also attempts to deter the behaviour with increased penalty times.<sup>772</sup> Section 36 of the PJA also amended § 3 of the CMA.<sup>773</sup> Originally, § 3 of the CMA made the offence regarding modification; however, it was changed to impairment with the PJA.<sup>774</sup> The new amendment was also implemented in order to satisfy the European Union Council Framework Decision on attacks against information systems requiring legislation against illegal system interference.<sup>775</sup> The offence’s penalty was also increased from five years to ten years.<sup>776</sup>

Section 37 of the PJA also enacted a new section to the CMA.<sup>777</sup> Section 3(A) criminalizes “the production, sale, procurement for use, import, distribution or otherwise making available of ... a computer password, access code, or similar data by which the whole or any part of a computer system is capable of being accessed’ when ‘committed intentionally and without right” for the purposes of committing illegal access, interception, or data or system interference offences.<sup>778</sup> The new section also criminalizes the creation, supply, or application of “hacker tools” for use in computer misuse offences, such that a

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<sup>768</sup> Ibid.

<sup>769</sup> Police and Justice Act 2006, c. 48 (Eng.).

<sup>770</sup> Ibid. at § 35.

<sup>771</sup> Ibid.

<sup>772</sup> Stefan Fafinski, The Uk Legislative Position on Cybercrime: A 20-Year Retrospective, 13 J. INTERNET L. 3, 10 (2009)

<sup>773</sup> Police and Justice Act 2006, c. 48, § 36.

<sup>774</sup> Fafinski, *supra* note 772, at 10.

<sup>775</sup> Council Framework Decision (EU) 2005/222/JHA of 24 Feb. 2005 on attacks against information systems [2005] OJ L69/67.

<sup>776</sup> Computer Misuse Act 1990 c. 18, § 3.

<sup>777</sup> Ibid. at § 3(A).

<sup>778</sup> Ibid.

person is guilty of an offence if he “supplies ... any article intending it to be used to commit, or assist in the commission of [a computer misuse offence]” or “believing that is likely to be used to commit, or assist in the commission of [any such offence].”<sup>779</sup> Obtaining such an article with the intent to supplying it to commit an offence can also be criminalized.<sup>780</sup> Despite the changes of a lesser mens rea for section 3 crimes an additional offence, the CMA still also contains its own flaws. Impairment can be very subjective for section 2 offences.<sup>781</sup> Although the new section 3A offences under the CMA would seem to allow opportunity for greater prosecution of cyber offences, the amount of prosecutions seemed to have dropped, despite the increasing cost of cybercrimes.<sup>782</sup>

### **Computer Crimes: A Problem for the International Community to Solve?**

Cyber financial crimes are easy and inexpensive to commit in comparison with traditional crimes, and attackers can easily evade prosecution by being in countries that will not arrest them.<sup>783</sup> As noted above, financial institutions, and particularly international ones, are prime targets for cyber criminals to commit fraud and embezzlement.<sup>784</sup> Black markets have developed online which enables organized crime to sell stolen identity and financial information as well as software programs to perpetrate cybercrimes.<sup>785</sup> Although developing an international standard for addressing cybercrimes is difficult, considering the global nature of the threat to financial wellbeing of countries along with the national security issues leads to the idea that an attempt is needed.

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<sup>779</sup> Ibid.

<sup>780</sup> Ibid.

<sup>781</sup> MacEwan, *supra* note 747, at 965.

<sup>782</sup> See John Leyden, *UK Prosecutions for Hacking Appear to be Dropping*, THE REGISTER, May 18, 2012, available at [http://www.theregister.co.uk/2012/05/18/uk\\_hacking\\_prosecutions\\_decline/](http://www.theregister.co.uk/2012/05/18/uk_hacking_prosecutions_decline/) (relaying that the number of prosecutions for serious offences under the CMA dropped from eighteen in 2006 to eight in 2010).

<sup>783</sup> UK Cyber Security Strategy, *supra* note 743, at 6; see also *President's working on Unlawful conduction on the Internet, the electronic frontier: The Challenges Unlawful Conduct Involving the Use of the Internet* 41 (2000), available at <http://www.usdoj.gov/criminal/cybercrime/unlawful.pdf>. (“When one country’s laws criminalize high-tech and computer-related crime and another country’s laws do not, cooperation to solve a crime, as well as the possibility of extraditing the criminal to stand trial, may not be possible. Inadequate regimes for international legal assistance and extradition can therefore, in effect, shield criminals from law enforcement: criminals can go unpunished in one country, while they thwart the efforts of other countries to protect their citizens”).

<sup>784</sup> Eisenberg et al., *supra* note 616, at 725.

<sup>785</sup> Ibid.

Nevertheless, measures aimed at targeting criminal proceeds and the prevention and control of fraud have not been sufficiently addressed in measures combating cybercrimes.<sup>786</sup> Connections between identity theft and terrorism have been established already.<sup>787</sup> Additionally, drug traffickers have also been known to engage in identity theft to finance their activities.<sup>788</sup> Criminals have found countless ways to exploit vulnerabilities and take advantage of financial institutions, businesses, and individuals in order to commit further crimes.<sup>789</sup> Stronger measures addressing these connections are needed to ensure prevention, detection and deterrence.

While there is no set definition of “cybercrime” or “computer crime,” many industrialized countries have amended their legislation to address four issues created by cybercrimes: (1) protection of privacy; (2) prosecution of economic crimes; (3) protection of intellectual property; and (4) procedural provisions to help in the prosecution of computer crimes.<sup>790</sup> Although the debate has been ongoing whether separate and distinct legislation is needed for cybercrimes, it seems that existing substantive criminal law is inadequate to handle the threats and development of cybercrimes. Governments should adopt computer-specific criminal legislation to address unauthorized access and manipulation of data and programs, similar to the United States and United Kingdom.<sup>791</sup>

In addition to the domestic change in laws, greater international cooperation efforts should be developed. A great step in this direction was the Council of Europe’s Convention

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<sup>786</sup> Financial Crimes, *supra* note 642, at 137.

<sup>787</sup> Bob Sullivan, Your Evil Twin: Behind the Identity Theft Epidemic, 122-40 (2004).

<sup>788</sup> *Ibid.* at 150-52.

<sup>789</sup> See generally Money Laundering & Terrorist Financing Vulnerabilities of Commercial Websites and Internet Payment Systems, FATF (2008) available at <http://www.fatf-gafi.org/media/fatf/documents/reports/ML%20TF%20Vulnerabilities%20of%20Commercial%20Websites%20and%20Internet%20Payment%20Systems.pdf> (discussing the potential vulnerabilities of online commercial websites and payment systems)

<sup>790</sup> See Ulrich Sieber, Computer Crimes and Other Crimes Against Information Technology: Commentary and Preparatory Questions for the Colloquium of the AIDP in Wuerzburg, 64 REV. INT’L DE DROIT PENAL 67, 69-70 (1993).

<sup>791</sup> See Douglas H. Hancock, To What Extent Should Computer Related Crimes be the Subject of Specific Legislative Attention, 12 ALB. L.J. SCI. & TECH. 97, 106 (2001) (commenting that criminal prosecutors often had great difficulty applying common law principles to computer crimes).

on Cybercrime.<sup>792</sup> Fifty-five countries, including the United States and United Kingdom have signed the treaty, indicating a positive step towards international harmonization of cybercrime laws.<sup>793</sup> Another attempt is the participation of countries in the Subgroup on High-Tech Crime at G-8's Lyon Group, which the United States is also a part of.<sup>794</sup> The Subgroup has achieved a network which assists law enforcement authorities of member countries to contact one another for assistance in investigating cybercrimes and preserving electronic evidence.<sup>795</sup>

The most critical information for combating cyber financial crimes is held by the private sector, the victims of many of the attacks such as banks, payment card providers, online banking services, and money transmitters). The financial sector must consider who is responsible for handling cybercrimes, assess where the threats are coming from and learn to respond appropriately. This requires a holistic and untied response and cannot be viewed as simply an information technology problem.<sup>796</sup> Awareness and transparency are critical for combating cybercrimes. Moreover, a lack of transparency can hide the true nature of the risks involved and prevent law enforcement from aiding in investigations and prosecutions.<sup>797</sup>

Reporting cybercrimes is an essential point that all nations must ensure. Several states in the U.S. have adopted state laws that require consumer notification when a business' has been breached.<sup>798</sup> Many of the state laws allow for a delay in the notification

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<sup>792</sup> Council of Europe Convention on Cybercrime – Budapest, 23 .XI.2001 (ETS No. 185) (2002) available at <http://conventions.coe.int/Treaty/EN/cadreprojets.htm> (requiring Parties to the treaty to ((i) establish substantive laws against cybercrime; (ii) ensure that their law enforcement officials have the necessary procedural authorities to investigate and prosecute cybercrime effectively; and (iii) provide international cooperation to other parties in the fight against computer-related crime intending to address substantive law, procedural powers, and international cooperation).

<sup>793</sup> Council of Europe, Chart of Signatures and Ratifications, *available at* [http://conventions.coe.int/Treaty/Commun/QueVoulezVous.asp?NT\\_185&CM\\_1&DF\\_08/11/2010&CL\\_ENG](http://conventions.coe.int/Treaty/Commun/QueVoulezVous.asp?NT_185&CM_1&DF_08/11/2010&CL_ENG)

<sup>794</sup> Fighting Cybercrime: Hearing Before the sub-committee. on Crime of the H. Comm. on the Judiciary, 107th Cong. 1 (2001) (statement of Michael Chertoff, Assistant Attorney General. Criminal Division), *available at* <http://judiciary.house.gov/legacy/72616.pdf>.

<sup>795</sup> *Ibid.*

<sup>796</sup> CLARK ET AL., *supra* note 595, at 4 (finding that the threat can be targeted at various departments in an institution and each must be aware of this threat).

<sup>797</sup> *Ibid.*

<sup>798</sup> Peretti, *supra* note 588, at 407.

if law enforcement deems it to hinder the criminal investigation.<sup>799</sup> Nevertheless, the reporting requirement is vital and necessary for law enforcement to determine where the breach came from and who is behind the act. Additionally, although notification may cause consumers to lose confidence, it is critical for them also to be aware of the threats and the realities of the situation.<sup>800</sup> Although it can be difficult to detect when a breach has occurred, each country should provide a reporting protocol in order to accomplish these objectives. While it is not possible to eradicate all vulnerabilities in a system, there are several ways to reduce them and to work towards a better practice.<sup>801</sup> Vulnerabilities continue to exist due to poor security practices and procedures, inadequate training on the threat of cybercrimes, and bad choices in software products designed to help protect computer systems and networks.<sup>802</sup> The U.S. Government has found that approximately eighty percent of successful hacks into federal computers have been the result of software errors and poor software quality.<sup>803</sup> Businesses, and in particular financial institutions, must be aware of these issues and take action to ensure they are installing and utilizing the best software for their protection. However, in addition to the private sector practicing their due diligence, regulators and legislators need to implement legal mechanism or liability for software manufacturers.<sup>804</sup>

As stated, the approach to combating cybercrimes is to take a holistic approach. It is not enough to rely on the private sector to act with due diligence, particularly if there is a loophole in the chain of events. A regulatory commission to oversee the software industry in order to minimize vulnerabilities could help deter and limit cybercrimes.<sup>805</sup> Regulators could also enlist regulatory guidelines on designing computer codes that developers can follow to also minimize the risks. Many software companies outsource their production to

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<sup>799</sup> Ibid.

<sup>800</sup> Ibid.

<sup>801</sup> Clay Wilson, *Computer Attack and Cyber Terrorism: Vulnerability and policy Issues for Congress*, 15, Cong. Research Serv., RL 32114, (2003).

<sup>802</sup> *See e.g., id.* (observing that IT specialist fail to install security patches in a timely manner or that commercial software designers release products which can cause vulnerabilities).

<sup>803</sup> Ibid. at 34.

<sup>804</sup> Ibid. (remarking that there is no regulatory mechanism or legal route for liability for defective products since many contain licensing agreements to protect vendors from liability).

<sup>805</sup> Ibid.

foreign countries, which can lead to errors designed to harm.<sup>806</sup> Security processes could be enabled in order to better protect computer systems and networks. Software companies also should not be able to contract away their liability if they do not follow guidelines or regulatory standards.

Greater cooperation and a realization of the need for international efforts are critical. Both the United States and United Kingdom have paved the way to demonstrate that separate and distinct criminal codes are needed to tackle the threat of cyber criminals. However, more must be done on all fronts to ensure the gaps between nations are filled. Countries have not taken full advantage of the opportunities provided by international agreements and recommendations.<sup>807</sup> Since sometimes conflict with local regulations on data privacy, data usage, handling of information reported to the authority, and other matters, which Financial Institutions to retain information and self-standing IT systems within a subsidiary or jurisdiction.<sup>808</sup> Each country must fully invest in the means needed to protect not only its national interest, but also the international community's in order to be successful.

## **Conclusion**

Cybercrime is a network of criminals that can be found anywhere in the world. Criminals utilizing the cyber domain are not left unconstrained, financial institutions and enforcement authorities are helping to enforce new anti-terrorism and cyber-related law and has made it much more difficult for criminal to influence the enormous profit potential found in the execution of cybercrimes.

The interconnected nature the Internet has provided makes it critical to achieve international consistency in criminalization of cybercrimes. As the world becomes more and more dependent on the internet, it has become clear that cyber criminals are quick to

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<sup>806</sup> Ibid.

<sup>807</sup> Financial Crime, *supra* note 642, at 142.

<sup>808</sup> Basel Committee on Banking Supervision, "Standardized Measurement Approach for operational risk" Consultative documents, Basel, March 2016.

develop the tools and infrastructure needed to access and exploit for financial gain. It is no secret that the threat of cyber financial crimes is great and continues to grow. The threat of cybercrimes cannot be overstated.<sup>809</sup>

The problem of cybercrime presents a conundrum that exposes the manner in which the law is able to tackle progressive technology. Nevertheless, any strategy to combat cyber financial crimes must entail search, seizure and confiscation of the proceeds. Success can only be achieved through cooperation of nations though. Cyber financial crimes are global in nature and must be treated as such. International organizations and private corporations are also working to combat the international threat of cybercrimes by contributing to the efforts of harmonizing national legislative efforts.<sup>810</sup>

Next chapter examines regulatory compliance in the financial sector as key tool for financial stability and the role of international financial institutions in setting mandates for banks and financial institutions.

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<sup>809</sup> Ibid.

<sup>810</sup> Cole Durham, *The Emerging Structures of Criminal Information Law: Tracing the Contours of a New Paradigm: General Report for the AIDP Colloquium*, 64 REV. INT'L DE DROIT PENAL 79, 97-109 (1993) (reporting efforts by Council of Europe, Organization for Economic Co-operation and Development, and United Nations).

## CHAPTER 5

### COMPLIANCE

#### Introduction

Over the past decade, safeguarding financial stability has become an increasingly dominant objective in economic policymaking, this will be illustrated by the periodic Financial Stability Report that has been launched by more than a dozen central banks and several international financial institutions (including the IMF, the Bank for International Settlements (BIS), and the World Bank), as well as by more prominent place given to financial stability in many of these institutions' organizational structures and mandates.<sup>811</sup> Therefore, protecting financial stability has become an increasingly dominant objective in compliance and is on the minds of just about every congress person, regulator, lawyer, and financial service professional. Financial institutions are coming under the crossfire as regulatory agencies continue to release new rules in order to maintain safe and effective markets.<sup>812</sup> The concept of compliance has developed over recent years. Gone are the days when satisfactory compliance for a bank consisted of making sure that a set of rules provided by a regulator had been met and each could be "ticked off and that appropriate returns had been sent in. Now the accepted approach is one of ascertaining the risks facing the institution and adopting appropriate measures to manage them. Regulatory guidelines are a tool to this end.<sup>813</sup>

The entire financial industry is revamping compliance programs to meet the evolving demands of a variety of federal, state, and even international regulators.<sup>814</sup> As a

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<sup>811</sup> Aerdt Houben, Jan Kakes, and Garry Schinasi, *Toward a Framework for Safeguarding Financial Stability* IMF's working paper. 2004 WP/04/101

<sup>812</sup> Melanie Grindle, *Innovation in Legislative Measures to Prevent White Collar Crime*, COLUMBIA BUS. L. REV., May 5, 2015, <http://cblr.columbia.edu/archives/13352> (finding that legislators and regulators have been initiating creative deterrents such as offender registry and rewarding employees who report illegal banking activity).

<sup>813</sup> Dr. Andrew Haynes, *The effect articulation of risk-based compliance in banks*, p.1, Palgrave Macmillan Ltd 2005. <http://link.springer.com/article/10.1057/palgrave.jbr.2340188>.

<sup>814</sup> Victoria Rivkin, *After the Fall: The Rising Need for Compliance Lawyers in a Post-Financial Crisis World*, 18 BROOK. L. SCH. LAW NOTES, Fall 2013, at 20, 21 (2013).



result, compliance departments are becoming more important and more involved in the businesses as a means to eliminate regulatory violations and to avoid fines, or reduce them in the event of an offence.<sup>815</sup> Regulators understand that financial crime rates are increasing<sup>816</sup> and that the role of compliance and control must evolve from simply observing the laws to a much more integrated approach to address the situation. Financial institutions understand the need to certify adherence with the relevant rules and regulations in order to grow, merge, and prosper.<sup>817</sup> Although increased regulation is not a novel concept for the financial industry, anti-money laundering regulations have begun to be issued at a much more rapid pace.<sup>818</sup> Legislators have not only been sceptical of financial institutions and their compliance efforts, but also of federal regulators and their oversight.<sup>819</sup> In addressing the stricter scrutiny from keen regulators, banks will be required to increase costs to ensure they abide to tighter AML guidelines.<sup>820</sup> Investigations into recent banking scandals have demonstrated that compliance risk was worsened by globalized institutional structures that have become too complex to manage internally and

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<sup>815</sup> Jennifer Smith, *New Legal Pitfalls Abound--Cybercrime, Labor Rules, Financial Penalties Add to General Counsels' Concerns*, WALL ST. J., Jan. 6, 2014, at B6; Daniel M. Gallagher, Comm'r, SEC, Remarks at the 2013 Nat'l Compliance Outreach Program for Broker-Dealers (Apr. 9, 2013), available at [http://www.sec.gov/News/Speech/Detail/Speech/1365171515226#UvAMT\\_shMuc](http://www.sec.gov/News/Speech/Detail/Speech/1365171515226#UvAMT_shMuc).

<sup>816</sup> See Ginny Grimsley, *Why is White-Collar Crime on the Rise?*, River Cities Reader, Aug. 20, 2012, <http://www.rcreader.com/news-releases/why-is-white-collar-crime-on-the-rise/> (noting that white-collar crimes in the United State alone has increased by 17.8 percent).

<sup>817</sup> Nick Allard, *Why Compliance Experts Are the New Key to Mega-Deals*, YAHOO! FINANCE (July 15, 2013, 3:19 PM), <http://finance.yahoo.com/blogs/the-exchange/why-compliance-experts-key-mega-deals-191921713.html>.

<sup>818</sup> See Press Release, *Opening Statement of Sen. Carl Levin: U.S. Vulnerabilities to Money Laundering, Drugs and Terrorist Financing: HSBC Case History* (July 17, 2012) [hereinafter *Levin Statement*] (recommending more severe penalties for non-compliance, including charter revocation); Greg Farrell, *Deutsche Bank Among Four Said to Be in U.S. Iran Probe*, BLOOMBERG (Aug. 18, 2012), <http://www.bloomberg.com/news/2012-08-18/deutsche-bank-among-four-said-to-be-in-u-s-laundrying-probe.html> (assuming that based on insider information that Deutsche Bank and three other unnamed banks would be the next to join the series of banks already subjected to investigations).

<sup>819</sup> Staff of the Permanent Subcomm. on Investigations, 112th Cong., Rep. On U.S. Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History (2012) [hereinafter *HSBC Report*], available at <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> (released in conjunction with the Permanent Subcomm. on Investigations' July 17, 2012 hearing, this report details the oversight from the Office of the Comptroller of the Currency as ineffective).

<sup>820</sup> Neil Katkov, *Trends in Anti-Money Laundering 2011* (2011), <http://amlcft.com/files/2011/09/Celent-AML-Trends-2011-2013-Report.pdf> (detailing the results of a survey of more than 75 financial institutions around the world regarding their current and projected costs of AML compliance).

regulate externally.<sup>821</sup> Accordingly, the role of compliance in financial institutions has moved to the top concerns of executives. However, the banking scandals that have occurred in recent years have shed light on important questions that must be resolved when concerning compliance. Fundamentally, the question that must be ascertained is how the oversight model as it currently stands is affecting the situation.

This chapter will discuss what compliance is by going over the compliance function and will also explore the importance of how compliance department is organized, as well as the role of the Compliance Officer and the use of monitoring software. Further, it will discuss the approaches taken by the United States and the United Kingdom regarding compliance, along with the Basel Committee on Banking Supervision and its principles. Lastly, the chapter will address compliance and anti-money laundering in Islamic banking and examine various case studies from the recent banking scandals. The chapter will conclude that there is a greater need for global integration on compliance and regulatory oversight.

### **The Meaning of Compliance**

Compliance, in its most basic terms, means to follow the law. It requires that an organization abides by all applicable legal requirements.<sup>822</sup> Thus, it can be said that compliance is a state of being in accordance with established guidelines, specifications and legislation.<sup>823</sup> The notion of compliance risk is also involved in compliance. Compliance risk is defined as “the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities.”<sup>824</sup> The financial industry is governed by many regulatory agencies in

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<sup>821</sup> Justin O'Brien & Olivia Dixon, *The Common Link in Failures and Scandals at the World's Leading Banks*, 36 SEATTLE U. L. REV. 941, 942 (2013) (arguing that this situation of compliance programs and attempt for deterrent regulation makes the system unfeasible).

<sup>822</sup> Martin T. Biegelman, *Building a World-Class Compliance Program: Best Practices and Strategies for Success*, 2 (2008).

<sup>823</sup> *Ibid.*

<sup>824</sup> Basel Comm. on Banking Supervision, *Compliance and the Compliance Function in Banks*, Bank for Int'l Settlements § 3 (Apr. 2005), available at <http://www.bis.org/publ/bcbs113.pdf> [hereinafter *Compliance and the Compliance Function in Banks*].

the United States including the Federal Reserve System (“Fed”), the Office of the Comptroller of the Currency (“OCC”), Federal Deposit Insurance Corporation (“FDIC”), and other agencies.<sup>825</sup> Financial institutions are required to strictly comply with financial regulations, which were first introduced in the Securities Act of 1933<sup>826</sup> (“1933 Act”). The 1933 Act was primarily concerned with public offerings of securities to prevent fraud and federally regulate the financial industry in response to the 1929 stock market crash that occurred during the Great Depression.<sup>827</sup> Since then, numerous other regulations have entered into force in order to monitor the dealings of financial institutions as well as to maintain the confidence of the market.<sup>828</sup> This chapter will primarily focus on the issue of compliance with anti-money laundering rules and regulations.

### **The Function of Compliance**

Modern day compliance departments began in 1977 with the requirements established in the Foreign Corrupt Practices Act (“FCPA”).<sup>829</sup> The FCPA entered into force following an investigation by the SEC which uncovered significant bribery activity within United States companies.<sup>830</sup> As a result, the FCPA ensured that companies established their own internal resources to “actively monitor” business activities to maintain compliance with the applicable rules and regulations.<sup>831</sup> Over the years, the function of the Compliance Department has evolved in order to keep up with regulations.

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<sup>825</sup> Stephen D. Simpson, The Banking System: Commercial Banking--How Banks Are Regulated, Investopedia, <http://www.investopedia.com/university/banking-system/banking-system6.asp>. The Federal Reserve primarily regulates state-chartered banks that are members of the Federal Reserve System, the OCC regulates national and federal savings bank associations, and the FDIC insures state-chartered banks that are not members of the Federal Reserve System.

<sup>826</sup> Securities Act of 1933, Pub. L. No. 111-229, 48 Stat. 74, available at <http://www.sec.gov/about/laws/sa33.pdf>.

<sup>827</sup> Securities Act of 1933, Cornell Univ. L. Sch., [http://www.law.cornell.edu/wex/securities\\_act\\_of\\_1933](http://www.law.cornell.edu/wex/securities_act_of_1933); see also Securities Laws, Rules, Regulations and Information, SECLAW.com, available at <http://www.seclaw.com/seclaw.htm>.

<sup>828</sup> Andrew Yu, Regulatory Financial Reform: Impact of Dodd-Frank Act on It Compliance? 38 Rutgers Computer & Tech. L.J. 254, 255-56 (2012) (outlining the history of the U.S. financial regulation).

<sup>829</sup> Miriam Baer, Governing Corporate Compliance, 50 B.C. L. REV. 949, 962 (2009).

<sup>830</sup> John MacKessy, Knowledge of Good and Evil: A Brief History of Compliance, Fin. Prof'ls' Post (May 26, 2010), <http://post.nyssa.org/nyssa-news/2010/05/a-brief-history-of-compliance.html>.

<sup>831</sup> Ibid.

Among other things, the Compliance Department is in charge of fulfilling an advisory role, monitoring the financial institution's adherence to the law and also educating those who work there. Although there are various regulations that provide the foundation for compliance programs, there are only a few specific guidelines for the particular roles and organization of the Compliance Department.<sup>832</sup> The functions of individual Compliance Departments can be many and cover a wide range depending on a financial institution's particular business activities and organizational structure.<sup>833</sup> However, there is a set of general responsibilities or functions normally associated with Compliance Departments. While these functions often reside in the Compliance Department, in some banks they may reside in, or be shared with, other control areas or business units.

### 1. Advisory

The Compliance Department is to provide regulatory and compliance advice to business and control units on a continuous basis.<sup>834</sup> This function may consist of responding to questions and issues that arise and proactively keeping the bank abreast of regulatory developments and any policy changes it has established itself internally. As such, in-house Compliance Departments are more favored so that personnel are able to address and advise the bank on issues in a timely manner.<sup>835</sup>

### 2. Guidance and education

Another core function is conducting training and educational programs in order to maintain all personnel apprised of policies and procedures and regulatory developments. Trainings are supposed to involve regularly scheduled updates in addition to trainings that are done on an as-needed basis when implementing new policies or procedures or to address regulatory changes that affect the compliance risk.<sup>836</sup> The Compliance Department is responsible for providing the staff with written guidance on implementation of

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<sup>832</sup> Compliance and the Compliance Function in Banks, *supra* note 824, at principle 7, at 13.

<sup>833</sup> Securities Industry Assoc., *The Role of Compliance 3* (White Paper, 2005).

<sup>834</sup> *Ibid.*

<sup>835</sup> *Ibid.*

<sup>836</sup> *Ibid.*

compliance laws, rules and standards as well as other documents such as compliance manuals, internal codes of conduct and practice guidelines.<sup>837</sup>

### 3. Identification, measurement and assessment of compliance risk

Compliance Departments are essential also in developing policies, procedures and guidelines developed to facilitate compliance with all applicable laws and regulations. They are also principally responsible for designing the Department's own policies and procedures, which are essential in defining the roles and responsibilities of the Compliance Department.<sup>838</sup> Assessing and measuring the bank's compliance risk is also a primary function. Additionally, it is critical for the Compliance Department to update or amend existing policies and procedures to address regulatory developments and the bank's compliance risk.

### 4. Monitoring, testing and reporting

The compliance function also demands constant monitoring and surveillance. This entails an in-depth review of business activities, as well as investigations into business transactions and communications to identify potential issues. Monitoring business activity enables ongoing compliance with firm policies and regulatory requirements by aiding to identify any patterns of improper behavior or activities in their early stages, material or systemic weaknesses and potential product-related problems. Compliance Departments will also test the effectiveness of supervisory procedures, often working with other control functions such as Internal Audit. There should be continuous reports to senior management on compliance matters.<sup>839</sup>

### 5. Statutory responsibilities and liaison

Often, Compliance Departments must also fulfill statutory responsibilities, such as the role of anti-money laundering officer.<sup>840</sup> This requires the Department to be involved

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<sup>837</sup> Ibid.

<sup>838</sup> Ibid.

<sup>839</sup> Ibid.

<sup>840</sup> Ibid.

in reviewing new accounts that are opened (“know your customer”) and monitor for any possible suspicious behaviour in customer transactions, including patterns of asset and fund movements.<sup>841</sup>

### **Compliance Program and the Role of the Compliance Department**

Financial institutions have an obligation to create effective compliance programs, reasonably designed to ensure compliance with applicable laws and regulations. Moreover, a compliance program should be incorporated as part of the bank’s general culture, with sufficient resources to operate effectively. Financial policymakers are well aware of the important role culture can play within financial services firms. The Basel Committee on Banking Supervision, for example, has observed that “[a] demonstrated corporate culture that supports and provides appropriate norms and incentives for professional and responsible behaviour is an essential foundation of good governance.”<sup>842</sup>

Despite the evolving and increased importance being placed on Compliance Department function, there is a distinction that must be drawn between the role of the Compliance Department and the overall responsibility the bank has to comply with applicable legal requirements. The general purpose of the Compliance Department is to advise a business on how to comply with all the legal requirements that are imposed on the business, and less, regulation, to monitor the business’ activities and employee conduct to identify any potential violations of rules, regulations, policies or industry standards. However, it is the senior management function that is responsible for supervising that the business is in fact achieving compliance. Compliance Department personnel are not

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<sup>841</sup> Basel Comm. on Banking Supervision, Core Principles for Effective Banking Supervision, Princ. 12, (Sept. 2012) (establishing that all banks should be required to “have adequate policies and processes, including strict customer due diligence (CDD) rules to promote high ethical and professional standards in the banking sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities”).

<sup>842</sup> Principles for Enhancing Corporate Governance, BCBS, 8, 22 (Oct. 4, 2010), available at <http://www.bis.org/publ/bcbs176.pdf> (“Sound corporate governance is evidenced, among other things, by a culture where senior management and staff are expected and encouraged to identify risk issues as opposed to relying on the internal audit or risk management functions to identify them. This expectation is conveyed not only through bank policies and procedures, but also through the ‘tone at the top’ established by the board and senior management.”).

generally entitled to correct wrongful conduct, nor authorize or approve transactions. The supervisors are those with the power to make such judgments. The focus on Compliance Departments has developed as a consequence of the financial industry's desire to build a culture of compliance.<sup>843</sup> This has been a natural growth from regulators encouraging the Compliance Department personnel to take a more proactive role in the compliance program. Thus, banks have begun to place more resources into their Compliance Departments. Nevertheless, such a proactive role does not substitute the nature of the Compliance Department and where senior management is supposed to be the ones who handle the liability of the business who fails to comply.<sup>844</sup>

### **Organizing Compliance Department at Financial Institutions**

Compliance departments can be organized in various ways depending on how an organization wishes to address its compliance risk.<sup>845</sup> In the early 1960s, stand-alone compliance departments began to develop. Before that time, the duty of monitoring compliance fell to legal firms. The need for stand-alone departments emerged as financial institutions sought the need for advice and support regarding the diverse responsibilities and regulations to apply on a day-to-day basis. The stand-alone compliance department offered the ease and ability to continue to determine the firm's compliance status while also expanding its functions in order to continue to be increasingly efficient. A financial institution's compliance department can vary by size depending on its functions, resources, etc. There is no mandated regulation for how an institution is to develop and maintain its compliance department because regulators understand that this is not a "one size fits all" issue.<sup>846</sup> A compliance department may interact or even share functions with an assortment of different control areas within an institution, including the legal department, internal audit

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<sup>843</sup> The Role of Compliance, *supra* note 833, at 11.

<sup>844</sup> See Wong Teck Kow, *Compliance Function in Financial Institutions* (2006) ("The prime responsibility to ensure that the business complies with regulations rests with the board of directors, or with the owners or the most senior executive management group where there is no board").

<sup>845</sup> *Ibid*

<sup>846</sup> See Fed. Fin. Inst. Examination Coun., Bank Secrecy Act/Anti-Money Laundering Examination Manual 23 (2014), *available at*, [https://www.ffiec.gov/bsa\\_aml\\_infobase/pages\\_manual/OLM\\_007.htm](https://www.ffiec.gov/bsa_aml_infobase/pages_manual/OLM_007.htm) [hereinafter BSA/AML Examination Manual] (observing that banks must take into account various factors when creating AML compliance program).

and risk management.<sup>847</sup> The Compliance Department may also be required to report to the General Counsel, Risk Management or directly into the Executive office. Furthermore, a Compliance Department may operate in a centralized manner, across functional lines or across business sections.<sup>848</sup> However, as a general rule, given that the Compliance Department is established as a control function, its personnel should not report to any revenue generating business units. The Compliance Department should maintain a close connection to senior management, who are accountable for a firm's overall compliance efforts.<sup>849</sup> Regardless of how a Compliance Department is organized, its reporting requirements as well as overall functions should be clearly defined in writing.<sup>850</sup> This includes separating Compliance Department functions from the supervisory functions of line managers, as well as distinguishing the roles of the Compliance Department from other control functions.<sup>851</sup>

### **Role of the Compliance Officer and Monitoring Software**

Considering the importance being placed on compliance departments, chief compliance officers (“CCO”), who head these departments, are also gaining prominence.<sup>852</sup> In a slumped job market, commentators have noted that the compliance field is “booming.”<sup>853</sup> The position of the CCO was first established in a marked way in

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<sup>847</sup> The Role of Compliance, *supra* note 833, at 2.

<sup>848</sup> *Ibid.*

<sup>849</sup> Compliance and the Compliance Function in Banks, *supra* note 824, at 9, principle 1-2 (establishing that the bank's board of directors is responsible for overseeing the management of the bank's compliance risk while the senior management is responsible for the effective management of the compliance risk).

<sup>850</sup> *Ibid.* at principle 3 (requiring the senior management to have a written compliance policy “that contains the basic principles to be followed by management and staff, and explains the main processes by which compliance risks are to be identified and managed through all levels of the organization. Clarity and transparency may be promoted by making a distinction between general standards for all staff members and rules that only apply to specific groups of staff”).

<sup>851</sup> *Ibid.*

<sup>852</sup> Former SEC Compliance Chief Asks Chairwoman White to Stop Suing Compliance Officers, Market Counsel, [marketcounsel.com/2013/06/26/former-sec-compliance-chief-asks-chairwoman-white-to-stop-suing-compliance-officers](http://marketcounsel.com/2013/06/26/former-sec-compliance-chief-asks-chairwoman-white-to-stop-suing-compliance-officers); Christian J. Mixer, ALI-ABA Mutual Fund Regulation and Compliance Conference, July 19-20, 2012; Mark Schoeff Jr., Crucial SEC Vote Leaves Compliance Officers in the Dark, Investment News (Jan. 27, 2012, 3:39 PM), [www.investmentnews.com/article/20120127/FREE/120129924](http://www.investmentnews.com/article/20120127/FREE/120129924) (noting compliance professionals “are nervous about the SEC's initiative targeting compliance” and worrying about liability issues).

<sup>853</sup> Gregory J. Millman & Samuel Rubinfeld, Compliance Officer: Dream Career? Wall St. J. (Jan. 15, 2014, 8:13 PM), <http://online.wsj.com/news/articles/SB10001424052702303330204579250722114538>; see also Aruna Viswanatha, Wall Street's Hot Trade: Compliance Officers, Reuters (Oct. 9, 2013, 4:35



1991 as a response to the enactment of the Federal Sentencing Guidelines (the “Guidelines”).<sup>854</sup> The principles underlying the Guidelines for corporations were “to recognize an organization's relative degree of culpability; and to encourage desirable organizational behaviour” a carrot and stick approach to govern corporate crime.<sup>855</sup> Compliance officers work to detect risks and develop targeted trainings and policies, along with tailored monitoring programs to address potential risks and deter misconduct.<sup>856</sup> A bank’s board of directors must designate a qualified individual to serve as the Bank Secrecy Act (“BSA”) compliance officer.<sup>857</sup>

In the U.K., all firms are to allocate responsibility for anti-money laundering systems and controls to a director or senior manager and all appoint a Money Laundering Reporting Officer (“MLRO”), who is to act as a focal point for the firm’s anti-money laundering activity.<sup>858</sup> As such, various laws require the compliance officer’s consideration to safeguard a company from illegal behaviour. The compliance officer is charged with monitoring all day-to- AML compliance.<sup>859</sup> The compliance officer is also responsible with managing all aspects of the AML compliance program as well as managing the bank’s adherence to the AML laws and their implementing regulations.<sup>860</sup> The compliance officer is to be fully knowledgeable of all AML laws and regulations.<sup>861</sup> They should also understand the bank’s products, services, customers, entities, and geographic locations, and

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PM), <http://in.reuters.com/article/2013/10/09/us-usa-banks-compliance-idINBRE9980EE20131009> (noting a “red-hot market” for CCOs).

<sup>854</sup> Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts about Their Future*, 71 WASH. U. L. Q. 205, 209 (1993)

<sup>855</sup> *Id.* at 228.

<sup>856</sup> Emmanuel Olaoye, *After SAC. Corporate Monitor Says What Makes Effective Compliance Programs*, REUTERS (Nov. 14, 2013), <http://blog.thomsonreuters.com/index.php/interview-after-sac-corporate-monitor-says-what-makes-effective-compliance-programs/>.

<sup>857</sup> The bank must designate one or more persons to coordinate and monitor day-to-day compliance. This requirement is detailed in the federal banking agencies' BSA compliance program regulations: 12 CFR 208.63, 12 CFR 211.5(m), and 12 CFR 211.24(j) (Federal Reserve); 12 CFR 326.8 (FDIC); 12 CFR 748.2 (NCUA); 12 CFR 21.21 (OCC).

<sup>858</sup> Financial Conduct Authority, *Anti-Money Laundering* (2014),

[https://www.ffiec.gov/bsa\\_aml\\_infobase/pages\\_manual/OLM\\_007.htm](https://www.ffiec.gov/bsa_aml_infobase/pages_manual/OLM_007.htm) [hereinafter FCA AML]

<sup>859</sup> Fed. Fin. Inst. Examination Coun., *Bank Secrecy Act/Anti-Money Laundering Examination Manual 32* (2014), available at, [https://www.ffiec.gov/bsa\\_aml\\_infobase/pages\\_manual/OLM\\_007.htm](https://www.ffiec.gov/bsa_aml_infobase/pages_manual/OLM_007.htm) [hereinafter BSA/AML Examination Manual].

<sup>860</sup> Antoinette Verhage, *The Anti Money Laundering Complex and Compliance Industry* 57 (2011).

<sup>861</sup> Olaoye, *supra* note 856, (commenting that although many compliance officers have a legal background to aid in interpreting and applying the rules and regulations, those lacking the legal background have the support of experience from working in the business area).

the potential money laundering and terrorist financing risks associated with those activities.<sup>862</sup> They must be experts in the field, simply hiring a compliance officer does not mean the bank is in compliance with the law if the person is not fully qualified.<sup>863</sup> The officer must also report any suspicious behaviour to relevant authorities.<sup>864</sup> They are also responsible for developing policies, procedures and controls to combat money laundering.<sup>865</sup> Providing advice is also a primary responsibility of the compliance officer.<sup>866</sup>

As a means to detect potential money laundering schemes more effectively, many financial institutions have established anti-money laundering detection solutions and enterprise-wide procedural programs.<sup>867</sup> However, in order to be more effective, AML technologies have emerged with the capacity to monitor transactions, identify a variety of suspicious behaviours, and also alert officials of the activity.<sup>868</sup> Defined broadly, AML software is a type of computer program used by financial institutions to analyse customer data and detect suspicious transactions.<sup>869</sup> These software systems filter customer data, classify it according to the level of suspicion and inspect it for anomalies.<sup>870</sup> Similarly, the software can be used to detect behaviour that attempts to circumvent the law.<sup>871</sup> AML software can also be designed to flag transactions that involve blacklisted countries or even individuals.<sup>872</sup> A report is generated after the flagged data has been identified. The compliance officer then evaluates and investigates the flagged transactions listed in the

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<sup>862</sup> BSA/AML Examination Manual, supra note 859, at 32; FCA AML, supra note 858.

<sup>863</sup> Ibid.

<sup>864</sup> Ibid. The MLRO is to report to the National Crime Agency (“NCA”) while the BSA compliance officer is to file Suspicious Activity Reports (“SARs”) with FinCen.

<sup>865</sup> Ibid.

<sup>866</sup> Verhage, supra note 860, at 58.

<sup>867</sup> Rajesh Menon & Sanjaya Kumar, Understanding the Role of Technology in Anti –Money Laundering compliance: A strategy Model for Financial Institutions. 2 (2005).

<sup>868</sup> Ibid.

<sup>869</sup> Margaret Rose, Anti-Money Laundering Software, (May 2008)

<http://searchfinancialsecurity.techtarget.com/definition/anti-money-laundering-software-AML>.

<sup>870</sup> Ibid. (listing anomalies such as sudden and substantial increase in funds or a large withdrawal).

<sup>871</sup> Ibid. (identifying customers who attempt to deposit large amounts of money through small deposits).

<sup>872</sup> Ibid.

report.<sup>873</sup> The software is essential in this day and age given that those involved in money laundering are highly organized and tech savvy as well.<sup>874</sup>

Next generation, behaviour-based technology utilizes advanced analytics when mining transactional and customer profile data to unravel intricate patterns of activity.<sup>875</sup> These new software are based on four risk assessment components that ensure disclosure and reporting that are required under AML laws.<sup>876</sup> These four include: Client Risk Assessment which uses detailed customer profiles to investigate purposes; Transaction Risk Measurement that identifies transactions with the greatest risks; Behaviour Detection Technology which recognizes suspicious patterns of behaviours; and Workflow and Reporting Tools that assist in alert investigations and compliance reporting.<sup>877</sup>

Effective AML software technology has become essential in compliance departments and to aid compliance officers. They must be customized to address each bank's needs and resources and continuously maintained. There should be global standards for what AML technology should do as a minimum benchmark in order to resolve issues of inadequacy. A proactive approach is nevertheless essential by compliance officers maintain and update the technology to ensure it is doing the absolute best in order for the program to be effective and efficient in detecting money laundering, and thus saving the financial institution from fines, regulatory action and reputational damage.

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<sup>873</sup> Ibid.

<sup>874</sup> Verafin, Complex Money Laundering Schemes: Using Advanced Technology to improve your Detection Efforts, [http://info.verafin.com/rs/verafin/images/Verafin\\_White\\_Paper\\_AML\\_Complexities\\_v2.pdf](http://info.verafin.com/rs/verafin/images/Verafin_White_Paper_AML_Complexities_v2.pdf).

<sup>875</sup> Ibid. at 6.

<sup>876</sup> Menon & Kumar, *supra* note 867, at 4.

<sup>877</sup> Ibid.

### **Personal liability of senior managers and compliance officers:**

The enormous financial penalties that have been imposed particularly in the USA and UK on financial institutions in recent years, primarily for compliance related failures, have been welcome by many.<sup>878</sup> On December 16, 2015, New York State Department of Financial Services (“DFS”) had proposed a new anti-money laundering (“AML”) and anti-terrorist financing rule applicable to DFS-regulated institutions would be required to maintain monitoring program to detect potential violations of the Bank Secrecy Act. In addition, the regulated institutions would be required to maintain a watch list filtering program to identify and interdict transactions prohibited by applicable sanctions and terrorist financing rules, including those promulgated by the U.S. Department of the Treasury’s Office of Foreign Assets Control (“OFAC”), politically exposed person (“PEP”) lists, and other internal watch lists.

A recent court decision and proposed regulation, chief compliance officers would be personally subject to both civil and criminal liability if their institution’s anti-money laundering compliance programs are incapable of detecting and stopping illicit transaction. A recent decision from a federal district court held that the compliance officers of a financial institutions can be held civilly liable for failing to ensure their institution’s compliance with the Bank Secrecy Act’s anti-money laundering provisions, (U.S. Department of Treasury v. Haider, No. 0:15-cv-01518), on this case the Treasury Department’s Financial Crimes Enforcement Network (FinCEN) alleged that MoneyGram’s former chief Compliance officer –Thomas Haider- failed to take sufficient action to terminate, and failed to file Suspicious Activities Reports (SARs) related to transactions he had reason to believe were related to money laundering, fraud, or other illegal activities. FinCEN fined him \$1 million.

The imposition of personal liability on chief compliance officers is part of the regulator’s broader interest in compliance failures at the highest levels of financial

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<sup>878</sup> Barry Rider, Karen Alexander, Stuart Bazley and Jeffrey Bryant: Market Abuse and Insider Dealing, 3<sup>rd</sup> Edition, (Bloomsbury Professional Ltd 2016). p. 339

institutions. The problem with swinging financial penalties against institutions, regardless of how they are imposed, is that they do not directly focus responsibility on those primarily responsible for the misconduct. Indeed, it is arguable that the penalties weaken the institution thereby harming investors, creditors, employees and many other shareholders. This will no doubt have implications for those in senior management, certainly in terms of reputation and possibly financially through the loss of incentives and even employment.<sup>879</sup>

The 2013 Act was passed as part of an ongoing process to improve the stability of the United Kingdom's banking system<sup>880</sup> The aims of the act are to separate retail banking deposits from wholesale banking activities by 2019 and to increase loss absorbency.<sup>881</sup> For this reason powers are granted to the PRA to facilitate this.<sup>882</sup> Higher standards are imposed on bankers' conduct by introducing a more stringent approval regime for senior managers and new certification regime is being brought in for those in 'significant responsibility functions'. A criminal offence of reckless misconduct is created and depositors are given priority on a bank's insolvency. Also the act itself covers the conduct of the people working in the industry.<sup>883</sup> According to section 36 of the Financial Services (Banking Reform) Act 2013, which imposes criminal liability on senior officers or banks and building societies for participation in decisions that cause their institution to collapse, in order to be liable it must be shown that their conduct, or failure to act, fell far below that standard that could reasonably be expected of persons in such a position.<sup>884</sup> Furthermore, the 2013 Act will ensure that senior managers can be held accountable for any misconduct that falls within their areas of responsibilities, the new Certification Regime and Conduct Rule aim to hold individuals working at all levels in banking appropriate standards of conduct. There is a tightening up of the approval of senior categories of approved persons and a strengthening of the capacity to vary any approval.<sup>885</sup> Misconduct is specifically stated to cover a relevant person failing to comply with a PRA or FCA requirements.<sup>886</sup> There is a noticeable

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<sup>879</sup> Ibid.

<sup>880</sup> Andrew Haynes, *Banking Reforms Struggles on*: Published by Oxford University Press 2014.

<sup>881</sup> Part 1 and Sch 1 Financial Services (Banking Reform) Act 2013.

<sup>882</sup> Ibid

<sup>883</sup> Ibid

<sup>884</sup> Ibid.

<sup>885</sup> Section 63 ZA to 63 ZE Financial Service and Markets Act 2000, as amended.

<sup>886</sup> Section 66 A and B *ibid*.

tightening of the responsibilities placed on senior people in banking and financial services institutions. Furthermore, both regulators and compliance officers need to achieve right balance in this current environment, Regulators may want to handle the issue of personal liability with balancing approach while propagating a stronger culture of compliance; whereas compliance professional may want to apply better methods in managing their individual accountability risk in order to avoid any regulatory disturbance, therefore, finding the right balance would be essential to promote financial stability, since the potential criminal liability will be difficult to determine.<sup>887</sup>

### **US & UK and the Basel Committee on Banking Supervision**

Anti-money laundering regulation is done on a national level, but is often based on principles established by international organizations such as the Basel Committee on Banking Supervision (“BCBS”), which is “hosted” by the BIS.<sup>888</sup> Basel itself is a coordinating mechanism. It thus creates loose agreements that do not rise to the level of legal requirements.<sup>889</sup> There are no treaties established to create binding agreements between countries who participate either.<sup>890</sup> The various Basel undertakings are formally non-binding.<sup>891</sup> Thus, members have no recourse to dispute settlement in the event a Basel signatory fails to carry out its Basel commitments. Basel law therefore does not produce a “direct effect” (to borrow a concept from EU law).<sup>892</sup> This is also the “Basel perspective,” in that the Basel rules do not pretend to have any automatic application. Rather Basel law

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<sup>887</sup> Ibid

<sup>888</sup> Basel Committee on Banking Supervision, Bank for Int'l Settlements, <http://www.bis.org/bcbs> (explaining the Committee “provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide”).

<sup>889</sup> See Basel Comm. on Banking Supervision, Bank for Int'l Settlements, A Brief History of the Basel Committee 1 (2013), available at <http://www.bis.org/bcbs/history.pdf> [hereinafter Basel Comm. History] (“The Committee's decisions have no legal force.”).

<sup>890</sup> See Kern Alexander, *Global Financial Standard Setting, The G10 Committees, and International Economic Law*, 34 BROOK. J. INT'L L. 861, 876 (2009) (“As an international legal matter, the Basel Capital Accord and its amended version, Basel II, are not legally binding in any way for G10 countries or other countries that adhere to it. The Capital Accord has been analyzed and classified as a form of ‘soft’ law.”).

<sup>891</sup> Basel Comm. History, *supra* note 889.

<sup>892</sup> “Direct effect” is a principle of EU law which permits Union law, if appropriately framed, confer rights on individuals, which the courts of Member States of the EU are bound to recognize and enforce. See Eur. Common, The Direct Effect of European Law, Europa.eu, [http://europa.eu/legislation\\_summaries/institutional\\_affairs/decisionmaking\\_process/114547\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/decisionmaking_process/114547_en.htm)

exists primarily to guide national implementation. The form of national implementation--whether by statute, regulation, guidelines or whatever--is left to national discretion.<sup>893</sup>

However, Basel does directly address the banks and other financial institutions which are the ultimate object of its strictures.<sup>894</sup> Banks expect the eventual application of Basel norms in the various jurisdictions in which they operate; as such, there is considerable practical effectiveness directly exerted by Basel norms.<sup>895</sup> In 2005, the Basel Committee recognized compliance risk as a distinct class of risk.<sup>896</sup> The Basel Committee went on to further outline ten principles that compliance functions within banking organizations should follow, covering aspects such as reporting lines to resourcing for compliance functions.<sup>897</sup> These principles have been incorporated into AML compliance program requirements in the U.S. and the U.K.<sup>898</sup> In January of 2014, the Basel Committee issued guidelines for the sound management of risks related to money laundering and financing of terrorism.<sup>899</sup> The AML sound management guidelines details how banks are to include the management of risks related to money laundering and financing of terrorism within their overall risk management framework.<sup>900</sup> The Basel Committee noted that “prudent management of these risks together with effective supervisory oversight is critical in protecting the safety and soundness of banks as well as the integrity of the financial

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<sup>893</sup> Alexander, *supra* note 890, at 874.

<sup>894</sup> Bryan J. Balin, *Basel I, Basel II, and Emerging Markets: A Nontechnical Analysis 2* (May 10, 2008) (part of unpublished graduate thesis, Johns Hopkins University), available at <https://jscholarship.library.jhu.edu/bitstream/handle/1774.2/32826/Basel%20I%20Basel%20II%20and%20Emerging%20Markets%20a%20Nontechnical%20Analysis052008.pdf?sequence=1>.

<sup>895</sup> Alexander, *supra* note 890, at 875.

<sup>896</sup> *Compliance and the Compliance Function in Banks*, *supra* note 824.

<sup>897</sup> *Ibid.* at 9. The ten principles the Basel Committee on Banking Supervision outlined were: 1) Responsibilities of the Board of Directors for Compliance: Overseeing Management of Bank's Compliance Risk; 2) Responsibilities of Senior Management for Compliance: Effective Management; 3) Responsibilities of Senior Management for Compliance: Establishing and Communicating Compliance Policy; 4) Responsibilities of Senior Management for Compliance: Establishing a Permanent and Effective Compliance Function; 5) Compliance Function Principles: Independence; 6) Compliance Function Principles: Resources; 7) Compliance Function Responsibilities: Assist Senior Management in Managing Effecting the Compliance Risks faced by the Bank; 8) Relationship with Internal Audit; 9) Cross-Border Issues; 10) Outsourcing.

<sup>898</sup> Vishal Melwani, *Refining Compliance Within Large Banking Organizations in A Post Sr 08-8 World*, 9 *BROOK. J. CORP. FIN. & COM. L.* 615, 621 (2015).

<sup>899</sup> Basel Committee on Banking Supervision, *Sound Management of Risks Related to Money Laundering and Financing of Terrorism* (Jan. 2014), available at <http://www.bis.org/publ/bcbs275.pdf>.

<sup>900</sup> Jenna Danko, *Tackling the New Basel Committee Guidelines on AML/FT Risk Management*, ORACLE (Jan. 2014), [https://blogs.oracle.com/financialservices/entry/tackling\\_the\\_new\\_basel\\_committee](https://blogs.oracle.com/financialservices/entry/tackling_the_new_basel_committee).

system. Failure to manage these vulnerabilities exposes banks to serious reputational, operational, compliance and other risks.”<sup>901</sup>

With the AML/FT guidelines, the Basel Committee outlines the “essential elements” to effective management of anti-money laundering and financing terrorism risk management, including those related to:

- Assessing, understanding managing and mitigating risks
- Customer acceptance policies
- Customer and beneficial owner identification, verification and risk profiling
- Management of information and record keeping
- Reporting suspicious transactions and asset freezing<sup>902</sup>

These guidelines are meant to address cross-border and group-wide context and details the expectations for banking supervisors that must be addresses. This also comes at a time when regional areas are looking into retooling their AML laws.<sup>903</sup> However, without causing a binding effect, the Basel Committee and their principles and guidelines issues serve merely as suggestions. Although many countries do take them into account, as can be seen through the Basel III Framework<sup>904</sup> implementation, when costs or political controversies enter, the international standards are not implemented as they should.<sup>905</sup>

In the U.S., the first federal law designed to limit money laundering was passed in 1970 as the Financial Recordkeeping and Reporting of Currency and Foreign Transaction

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<sup>901</sup> Ibid.

<sup>902</sup> Ibid.

<sup>903</sup> Jenna Danko, New Regulatory Measures Against Money Laundering: Are you Ready? ORACLE (Jan. 2014), [https://blogs.oracle.com/financialservices/entry/aml\\_the\\_next\\_frontier](https://blogs.oracle.com/financialservices/entry/aml_the_next_frontier) (discussing the U.S. plans to enhance AML requirements because there is a push for stricter regulation and supervision and also the increased use of internet and mobile banking).

<sup>904</sup> Hurberto M. Ennis & David A. Price, The Federal Reserve Bank of Richmond, Basel III and the Continuing Evolution of Bank Capital Regulation Economic Brief 1 (2011), *available at* [http://www.richmondfed.org/publications/research/economic\\_brief/2011/eb\\_11-06.cfm](http://www.richmondfed.org/publications/research/economic_brief/2011/eb_11-06.cfm) (explaining Basel III is a series of global financial regulations that respond to the Great Recession, the financial crisis of 2007-2009 and regarded as international regulation and rulemaking).

<sup>905</sup> Narissa Lyngen, *Basel III: Dynamics of State Implementation*, 53 HARV. INT'L L.J. 519, 520 (2012) (discussing that national level implementation of Basel III has been contentious and created political pressures that has affected its proper implementation).



Report Act, or better known as the Bank Secrecy Act (“BSA”).<sup>906</sup> The BSA required banks to maintain records and reports as a means to aid in “criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism.”<sup>907</sup> The records and reports were to aid in facilitating audits or for a paper trail for law enforcement and regulatory agencies in order for the transactions to be reconstructed or retraced when needed.<sup>908</sup> Title I of the BSA authorized the Secretary of the Department of the Treasury (Treasury) to issue regulations requiring recordkeeping from financial institutions.<sup>909</sup> Title II empowered the Treasury to prescribe the exact requirements concerning reports of transactions over \$10,000.<sup>910</sup>

Following amendments to the BSA, the next major AML law was the Money Laundering Control Act of 1986.<sup>911</sup> This piece of legislation imposed criminal liability of money laundering regulations, but also extended the reach of AML laws by defining “transaction”<sup>912</sup> and “financial transaction”<sup>913</sup> in a very broad manner in order to cover various activities. After the Annunzio-Wylie Anti-Money Laundering Act of 1992,<sup>914</sup> the Treasury had the power to impose criminal liability on a variety of institutions and individuals for wide ranging transactions.

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<sup>906</sup> 31 U.S.C. § 5311 (2006).

<sup>907</sup> Ibid.

<sup>908</sup> See, e.g., FDIC, See Bank Secrecy Act, Anti-Money Laundering, and Office of Foreign Assets Control, DSC Risk Management Manual of Examination Policies, 1 (2004) [hereinafter FDIC Manual], [http://www.ffiec.gov/bsa\\_aml\\_infobase/documents/FDIC\\_DOCs/BSA\\_Manual.pdf](http://www.ffiec.gov/bsa_aml_infobase/documents/FDIC_DOCs/BSA_Manual.pdf).

<sup>909</sup> Ibid.

<sup>910</sup> Ibid.

<sup>911</sup> 18 U.S.C. § 1956 (2006).

<sup>912</sup> 18 U.S.C. § 1956(c)(3) (2006) (defining “transaction” to include “a purchase, sale, loan, pledge, gift, transfer, delivery, or other disposition, and with respect to a financial institution includes a deposit, withdrawal transfer between accounts...or any other payment, transfer, or delivery by, through, or to a financial institution, by whatever means effected.”). Transactions subject to AML laws include those that do not involve financial institutions.

<sup>913</sup> 18 U.S.C. § 1956 (c)(4) (2006) (“The term ‘financial transaction’ means (A) a transaction which in any way or degree affects interstate or foreign commerce (i) involving the movement of funds by wire or other means, (ii) involving one or more monetary instruments, or (iii) involving the transfer of title to any real property, vehicle, vessel, or aircraft, or (B) a transaction involving the use of a financial institution which is engaged in, or the activities of which affect, interstate or foreign commerce in any way or degree.”). In *United States v. Skinner* (946 F.2d 176) (1991), the court upheld convictions for money laundering even though the activity was a series of uncomplicated cocaine sales, rather than traditional bank activity.

<sup>914</sup> 31 U.S.C. § 5318 (a)(4) (2006) (increasing the Secretary of the Treasury’s authority to include summoning powers).

Then in 2001, the Uniting and Strengthening America by Providing Appropriate Tools Required to Interpret and Obstruct Terrorism Act of 2001 (Patriot Act) was passed.<sup>915</sup> The 9/11 attacks exposed the vulnerability of American financial institutions to money laundering as investigations later made clear that the terrorists responsible utilized the U.S. financial system.<sup>916</sup> In turn, strong AML laws were issued in the Patriot Act of 2002 and agencies also began promulgated stringent regulations for financial institutions.<sup>917</sup> Of the sections relating to financial institutions, Section 312 enforced the most significant regulatory burden on banks and the greatest oversight burden on federal agencies.<sup>918</sup> Section 312 was an amendment to the BSA that “impos[ed] due diligence and enhanced due diligence requirements on U.S. financial institutions that maintain correspondent accounts for foreign financial institutions or private banking accounts for non-U.S. persons.”<sup>919</sup>

As discussed below in the context of the HSBC example, the correspondent accounts<sup>920</sup> of utmost concern and subject to heightened due diligence are those maintained by banks operating: (1) under an offshore banking license; (2) under a license issued by a country that has been designated as being non-cooperative with international anti-money laundering principles or procedures; or (3) under a license issued by a country designated by the Secretary of the Treasury as warranting special measures due to money laundering

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<sup>915</sup> See FDIC, Bank Secrecy Act, Anti-Money Laundering, and Office of Foreign Asset Control, DSC Risk Management Manual of Examination Policies 8 (2004),

[http://www.ffiec.gov/bsa\\_aml\\_infobase/documents/FDIC\\_DOCS/BSA\\_Manual.pdf](http://www.ffiec.gov/bsa_aml_infobase/documents/FDIC_DOCS/BSA_Manual.pdf).

<sup>916</sup> See Staff of the Permanent Subcomm. on Investigations, 112th Cong., Rep. On U.S. Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History (2012) [hereinafter HSBC Report], available at <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/us-vulnerabilities-to-money-laundering-drugs-and-terrorist-financing-hsbc-case-history> (released in conjunction with the Permanent Subcomm. on Investigations' July 17, 2012 hearing, this report details oversight from the Office of the Comptroller of the Currency as ineffective)

<sup>917</sup> See, e.g., Due Diligence Programs for Correspondent Accounts for Foreign Financial Institutions, 31 C.F.R. §§ 1010.605; 1010.610; 1010.630; 1010.670 (2012).

<sup>918</sup> See, e.g., Due Diligence Programs for Correspondent Accounts for Foreign Financial Institutions, 31 C.F.R. §§ 1010.605; 1010.610; 1010.630; 1010.670 (2012).

<sup>919</sup> USA Patriot Act, FinCEN, [http://www.fincen.gov/statutes\\_regs/patriot/index.html?r=1&id=312#312](http://www.fincen.gov/statutes_regs/patriot/index.html?r=1&id=312#312)

<sup>920</sup> The final rule implementing Section 312 and the Patriot Act itself define correspondent banking broadly as any account established for a foreign financial institution “to receive deposits from, or to make payments or other disbursements on behalf of, the financial institution, or to handle other financial transactions related to such foreign financial institution.” FACT SHEET, Section 312 of the USA Patriot Act, Final Regulation and Notice of Proposed Rulemaking, Financial Crimes Enforcement Network Department of the Treasury 1-2 (Dec. 2005).

concerns. Essentially, banks are required to demonstrate that they are reasonably capable of detecting suspicious activities given the high risk of money laundering inherent to designated correspondent accounts.<sup>921</sup>

The European Union adopted the First and Second Anti-Money Laundering Directives in 1991<sup>922</sup> and 2001.<sup>923</sup> The EU directives were based on the Forty Recommendations of the Financial Action Task Force (“FATF”).<sup>924</sup> The directives relied heavily on the suspicious transaction reporting (STR) and no-tipping-off (NTO) requirements, which are believed to aid in the ability of investigative authorities to monitor financial activity in order to prevent the use of the economic system for money laundering and/or the financing of terrorism. In 2005, the EU adopted the Third Anti-Money Laundering Directive,<sup>925</sup> based on the 2003 revision of the FATF Recommendations.<sup>926</sup> The European Economic Area countries, which included the U.K., were required to implement the Third Directive by the end of 2007.<sup>927</sup> The U.K. Parliament adopted the Money Laundering Regulations 2007 (“Regulations”) to implement the new customer due

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<sup>921</sup> 31 C.F.R. § 1010.610(b) (2012).

<sup>922</sup> Council Directive 91/308, 1991 O.J. (L 166) 77-83 (EEC). According to article 288 of the Treaty on the Functioning of the European Union, “A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.” Consolidated Version of the Treaty on the Functioning of the European Union art. 288, Oct. 26, 2012, 2012 O.J. (C 326) 171-72. Thus, each of the anti-money laundering directives was independently binding on the EU member states and it was mandatory on each state to implement policies consistent with each of the directives.

<sup>923</sup> Council Directive 2001/97, 2001 O.J. (L 344) 76-81 (EC).

<sup>924</sup> Established in 1989, the Financial Action Task Force (FATF) is an international organization composed of thirty-four member states and two regional organizations. Member states are typically represented by their ministries of finance or, in the case of the United States, the Department of the Treasury. The FATF aims to set standards to encourage the implementation of legal and regulatory policy in its member states to combat money laundering and terrorist financing. The FATF issues Recommendations, which are periodically revised, that reflect the standard policy principles to effectively combat money laundering and terrorist financing. The FATF imposes an ongoing review process upon its member states to determine the efficacy of anti-money laundering (AML) and combating the financing of terrorism (CFT) policies implemented in each member state. The FATF Recommendations are non-binding on the member states; however, it has been recognized as one of the most effective international organizations in encouraging policy reform to combat money laundering and terrorist financing, and to preserve the integrity of the international financial system. About the FATF, FIN. ACTION TASK FORCE, <http://www.fatf-gafi.org/pages/aboutus>.

<sup>925</sup> Council Directive 2005/60, 2005 O.J. (L 309) 15 (EC) [hereinafter 2005 EU Directive].

<sup>926</sup> John A. Terrill, II, Michael A. Breslow, *The Role of Lawyers in Combating Money Laundering and Terrorist Financing: Lessons from the English Approach*, 59 N.Y.L. Sch. L. Rev. 433, 438 (2015)

<sup>927</sup> 2005 EU Directive, *supra* note 925, at art. 45.

diligence (“CDD”) requirements of the European Union's Third Money Laundering Directive, which focused more on a risk based approach.<sup>928</sup>

However, the cornerstone of the U.K. AML regime is the Proceeds of Crime Act of 2002 (“POCA”),<sup>929</sup> which generally applies to all individuals in the United Kingdom. POCA has been found to have a significant impact on the U.K.’s ability to restrain, confiscate and recover proceeds of crime.<sup>930</sup> The primary AML provisions are contained in Part 7 of POCA, which impose criminal sanctions against individuals who participate in money laundering conduct in the United Kingdom. The statute also imposes criminal sanctions against individuals in certain industries and businesses who become aware of, or have reason to suspect, money-laundering offences and fail to report the same to the appropriate authorities.<sup>931</sup> Part 7 addresses the substantive offences of money laundering (sections 327-329), failure-to-disclose offences (sections 330-332), offences for tipping off (sections 333A-D) or obstructing an investigation (section 342), and miscellaneous definitional and interpretative provisions.

Monitoring suspicious activity is a critical part of AML efforts. POCA requires the disclosure of suspicious activity by (1) providing a defence to money laundering conduct for making a disclosure to criminal authorities and receiving consent to proceed with the conduct, and (2) making it a criminal offence when individuals and businesses in certain regulated sectors (including legal professionals in many practice areas) fail to disclose suspicious activity to the proper authorities.

Additionally, POCA shields the integrity of investigations by incorporating an NTO regime.<sup>932</sup> Although states such as the U.S. and U.K continue to work on their AML/FT laws and requirements, there are still issues with the global AML regime. Problems arise in the United States for example, where threats of criminal prosecution are

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<sup>928</sup> The Money Laundering Regulations, 2007, S.I. 2007/2157.

<sup>929</sup> Proceeds of Crime Act, (2002) c. 29 (U.K.) (Business in the Regulated Sector and Supervisory Authorities) Order 2003 (effective Mar. 1, 2004; amended at pt. 2, sch. 9, para. 4(1)(f)(g) by S.I. 2003/3074, art. 3).

<sup>930</sup> Int’l Monetary Fund, United Kingdom: Anti-Money Laundering/Combating the Financing of Terrorism Technical Note 7 (IMF Country Report No. 11/231, July 2011).

<sup>931</sup> Proceeds of Crime Act, (2002) c. 29 (U.K.).

<sup>932</sup> Proceeds of Crime Act § 333A;

not backed and breaches are routinely sanctioned by financial regulators through negotiated settlements.<sup>933</sup> As can be noted below in the case studies, there has been a lack of incentive for such “systemically important financial institutions”<sup>934</sup> to implement a comprehensive compliance program that extends beyond symbolism.<sup>935</sup> In the United Kingdom, the situation is even more challenging considering there is a failure to hold any individual accountable.<sup>936</sup> Trust, which is the foundation of banking and its regulation, has in consequence and for good reason diminished.

### **Case studies of AML violations**

Despite the ever-increasing regulatory measures to ensure compliance, there has been evidence of a culture of non-compliance by banks and deficient oversight from regulating agencies.<sup>937</sup> In the absence of sufficient compliance and meaningful oversight, money laundering will continue to be moved through the financial system, as can be seen by the following case studies.

#### **Riggs Bank**

The first high-profile Congressional investigation into anti-money laundering compliance began with Riggs Bank, following the passage of the Patriot Act in 2003.<sup>938</sup>

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<sup>933</sup> O’Brien & Dixon, *supra* note 821, at 942 fn2 (“A negotiated settlement agreement is a voluntary alternative to adjudication in which the prosecuting agency agrees to grant amnesty in exchange for the defendant agreeing to fulfill certain requirements such as paying fines, implementing corporate reforms, and fully cooperating with the investigation”).

<sup>934</sup> Defined as “financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.” Policy Measures to Address Systemically Important Financial Institutions, Fin. Stability Bd. 1 (Nov. 4, 2011), [http://www.financialstabilityboard.org/publications/r\\_111104bb.pdf](http://www.financialstabilityboard.org/publications/r_111104bb.pdf).

<sup>935</sup> O’Brien & Dixon, *supra* note 821, at 943.

<sup>936</sup> See Fin. Servs. Auth., *The Failure of the Royal Bank of Scotland* (Dec. 2011), <http://www.fsa.gov.uk/static/pubs/other/rbs.pdf>. (“Quite reasonably ... people want to know why RBS failed. And they want to understand whether failure resulted from a level of incompetence, a lack of integrity, or dishonesty which can be subject to legal sanction.”).

<sup>937</sup> See HSBC Report, *supra* note 916 (released in conjunction with the Permanent Subcomm. on Investigations' July 17, 2012 hearing, this report details oversight from the Office of the Comptroller of the Currency as ineffective).

<sup>938</sup> See Staff of the Permanent Subcomm. on Investigations, 108th Cong., Rep. On. Money Laundering and Foreign Corruption: Enforcement and Effectiveness of the Patriot Act: Case Study Involving Riggs Bank 1 (2004) [hereinafter Riggs Bank Report], *available at* <http://www.levin.senate.gov/imo/media/doc/supporting/2004/0924psireport.pdf> (released in conjunction with the

Senator Carl Levin, Ranking Minority Member, submitted a request to the Subcommittee on Investigations to investigate the “the enforcement and effectiveness of key anti-money laundering provisions in the Patriot Act, using Riggs Bank as a case study.”<sup>939</sup> The investigation revealed a poorly implemented AML program and a clear disregard to the bank’s compliance responsibilities.<sup>940</sup> Most notably, two of Riggs Bank’s accounts were found to be linked to Augusto Pinochet and Equatorial Guinea.<sup>941</sup> It was discovered that Pinochet, the former dictator of Chile, maintained personal accounts at Riggs Banks for at least eight years while under investigation and while under a worldwide court order for freezing his assets.<sup>942</sup> Riggs Banks served not just as Pinochet’s personal bank, but the accounts were initiated due to senior officers at the bank actively pursuing his business.<sup>943</sup> The Report alleged that Riggs participated in transactions in violation of AML laws for several years including deposits of money from unknown origins, the creation of offshore shell corporations, efforts to hide Pinochet’s involvement in cash transactions, and personal deliveries of cashier checks to Chile.<sup>944</sup> Riggs maintained a similar relationship with Equatorial Guinea, its officials, and their family members.<sup>945</sup> Pinochet was found to have deposits totaling between \$4 and \$8 million, while Equatorial Guinean officials along with

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Permanent Subcommittee on Investigations' Hearing on July 15, 2004, this report describes the AML deficiencies at Riggs Bank).

<sup>939</sup> Ibid.

<sup>940</sup> Press Release, FinCEN, U.S. Dep't of the Treasury, Assessment of Civil Money Penalty 8 (May 13, 2004), available at [http://www.fincen.gov/news\\_room/ea/files/riggsassessment3.pdf](http://www.fincen.gov/news_room/ea/files/riggsassessment3.pdf).

<sup>941</sup> James Rowley, *Riggs Bank Fined \$16 Mln for Helping Chile's Pinochet* (Update 5), BLOOMBERG, (March 29, 2005), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aDX6Lhj3.j3I>. Augusto Pinochet Ugarte took power on September 11, 1973. Although his time as leader helped with economic growth in Chile, thousands of citizens were executed or disappeared, and many others were detained, tortured or exiled. Equatorial Guinea is a small, oil-rich country in central Africa. The ruling elite has amassed a litany of human rights violations spanning fifty years under Francisco Macias Nguema and his nephew Teodoro Obiang Nguema. The totalitarian reality of life for the 700,000 citizens was “stolen elections, strict censorship, routine torture, and murdered dissidents.” Thor Halvorssen and Tutu Alicante, *How Dictators Triumph: With a Little Help From Their Friends*, The Huffington Post (August 6, 2012), [http://www.huffingtonpost.com/thor-halvorssen/how-dictators-triumph-wit\\_b\\_1789668.html](http://www.huffingtonpost.com/thor-halvorssen/how-dictators-triumph-wit_b_1789668.html).

<sup>942</sup> Terence O'Hara & Kathleen Day, *Riggs Bank Hid Assets of Pinochet, Report Says*, Washington Post (July 15, 2004), <http://www.washingtonpost.com/wp-dyn/articles/A50222-2004Jul14.html>

<sup>943</sup> Rowley, *supra* note 941.

<sup>944</sup> See Riggs Bank Report, *supra* note 938, at 19 (noting that Riggs changed the name on the accounts from “Augusto Pinochet Ugarte & Lucia Hiriart de Pinochet” to “L. Hiriart &/or A. Ugarte” to ensure the name Pinochet would not be noticed if searched). Timothy L. O'Brien, *At Riggs Bank, A Tangled Path Led To Scandal*, N.Y. Times, (July 19, 2004), <http://www.nytimes.com/2004/07/19/us/at-riggs-bank-a-tangled-path-led-to-scandal.html?pagewanted=all&src=pm>.

<sup>945</sup> See O'Brien, *supra* note 944 (finding that Riggs managed over sixty accounts and certificates of deposits for Equatorial Guinea).

their families maintained amounts of almost \$700 million, which in turn represented Riggs' largest relationship with a client.<sup>946</sup> Riggs Bank disregarded the unknown origins of the deposits and established shell corporations in order to conceal the beneficial ownership, among other misconduct.<sup>947</sup> The Congressional Report concluded that "the evidence demonstrates that the Pinochet and Equatorial Guinea accounts were not treated in an unusual manner but were the product of a dysfunctional AML program with long-standing, major deficiencies."<sup>948</sup>

### **HSBC Bank U.S.A., N.A. (HSBC-US)**

HSBC utilized clandestine financial vehicles such as the in bulk transferring of traveller's checks and cash to bearer share accounts and high-risk affiliate accounts, demonstrating an extended period of AML deficiencies.<sup>949</sup> HSBC's overall group policy in relation to its global affiliates was at its core contrary with AML laws and it failed to abide by enhanced due diligence requirements pursuant to BSA and Section 312.<sup>950</sup> The procedures required: (1) verification of the identity of the nominal and beneficial owners of an account; (2) documentation showing the sources of funds; and (3) enhanced scrutiny of accounts and transactions of senior foreign political figures.<sup>951</sup> As the U.S. affiliate to HSBC, HSBC-US provided access to the U.S. financial system to respondent banks that were located in high-risk jurisdictions or to those who provided services to high-risk

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<sup>946</sup> Ibid.

<sup>947</sup> Terence O'Hara, Riggs Bank Agrees to Guilty Plea and Fine, Washington Post (January 28, 2005), <http://www.washingtonpost.com/wp-dyn/articles/A41584-2005Jan27.html>

<sup>948</sup> Riggs Bank Report, supra note 938, at 4.

<sup>949</sup> See HSBC Report, supra note 937. HSBC-US provided millions of dollars per year to a Japanese bank by cashing travelers' checks. Bulk cash transfers were a part of the HSBC Mexico S.A. Banco (HBMX) money-laundering scheme and ultimately allowed HBMX to smuggle the more physical U.S. dollars to HSBC-US than any of its 80 affiliates. Over the course of a decade, HSBC-US allowed more than 2,000 customers to open bearer share accounts; these are high risk accounts in that ownership is assigned to whomever has physical possession of the shares, allowing secrecy as to the true beneficial owner. The HSBC-US office in Miami had over 1,600 bearer share accounts at its peak, while there were over 850 at HSBC-US New York. Id. at 277. This note uses HSBC-US instead of HBUS in hopes of avoiding confusion.

<sup>950</sup> See News Release, OCC, OCC Assesses \$500 Million Civil Money Penalty Against HSBC Bank USA, N.A. (Dec. 11, 2012), <http://occ.gov/news-issuances/news-releases/2012/nr-occ-2012-173.html>

<sup>951</sup> See FDIC, Bank Secrecy Act, Anti-Money Laundering, and Office of Foreign Asset Control, DSC Risk Management Manual of Examination Policies 30 (2004), [http://www.ffiec.gov/bsa\\_aml\\_infobase/documents/FDIC\\_DOCS/BSA\\_Manual.pdf](http://www.ffiec.gov/bsa_aml_infobase/documents/FDIC_DOCS/BSA_Manual.pdf).

clients.<sup>952</sup> HSBC group policy assumed that any affiliate within the group that owned fifty percent or more was meeting the AML law requirements. Thus, HSBC-US naively believed that it was not under the obligation to conduct due diligence as to the affiliate's AML compliance.<sup>953</sup> HSBC-US failed to hold affiliates in high-risk jurisdiction to higher scrutiny in order to determine the business it was entering into.<sup>954</sup> As a result, the policy HSBC held negligently ignored even basic due diligence standards that are to be met when opening a correspondent account with another financial institution by allowing exceptions for foreign affiliates not in accordance with the law.<sup>955</sup>

Correspondent accounts have been found to operate as a banking tool vulnerable to manipulation by foreign banks as a means to launder money over the last few decades.<sup>956</sup> A prime example of this is the relationship between HSBC-US and HSBC Mexico S.A. Banco (HBMX).<sup>957</sup> In 2002, HSBC group purchased Bital, a Mexican bank, which created HBMX. Although HBMX had no AML compliance program despite the widespread drug trafficking and money laundering occurring in Mexico, HSBC-US treated HBMX as a low risk affiliate.<sup>958</sup> An investigation later revealed that HBMX had accounts opened for high-risk clients, among them criminal currency exchange businesses and suspect corporations.<sup>959</sup> Such behaviour and lack of compliance adherence demonstrates the risks that occur and the dangers that are able to seep into the American financial system. HSBC's behaviour was found to have established an operation that was "a systemically

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<sup>952</sup> See Press Release, Opening Statement of Sen. Carl Levin: U.S. Vulnerabilities to Money Laundering, Drugs and Terrorist Financing: HSBC Case History 5 (July 17, 2012) [hereinafter Levin Statement].

<sup>953</sup> HSBC Report, supra note 15, at 5.

<sup>954</sup> See HSBC's Grilling, *What Comes Out in the Wash*, Economist (Jul. 18, 2012) [hereinafter, HSBC's Grilling], <http://www.economist.com/blogs/schumpeter/2012/07/hsbc's-grilling> ("The senator noted that the bank continued to operate in jurisdictions with secrecy laws; he asked whether it could ignore those limitations to meet America's transparency demands").

<sup>955</sup> HSBC Report, supra note 15, at 35.

<sup>956</sup> See USA Patriot Act, Pub. L. No. 107-156, 15 Stat. 272, 296 (2001).

<sup>957</sup> HSBC Report, supra note 15, at 35 (illustrating "how providing a correspondent account and U.S. dollar services to a high-risk affiliate increase[s] AML risks."

<sup>958</sup> HSBC Money Laundering Report: Key Findings, BBC News (December 11, 2012), <http://www.bbc.co.uk/news/business-18880269>.

<sup>959</sup> HSBC Report, supra note 937, at 35. The currency exchange businesses in Mexico are referred to as casa de cambios, used by criminals to launder funds by exchanging U.S. dollars or Mexican pesos prior to their being transmitted to an international account. Illegal Casa De Cambio Launderers More Than \$5 Million, The SAR Activity Review 3 (2001), [http://www.fincen.gov/law\\_enforcement/ss/pdf/032.pdf](http://www.fincen.gov/law_enforcement/ss/pdf/032.pdf). The corporations of concern were later proven to be shell corporations used to launder funds from illegal drug sales in the United States. HSBC Report, supra note 937, at 35.



flawed sham paper-product designed solely to make it appear that the Bank has complied<sup>960</sup> with the Bank Secrecy Act<sup>961</sup> and other anti-money laundering (AML) laws, such as the Foreign Corrupt Practices Act.<sup>962</sup> It was found that between 2007 and 2008, HBMX moved \$7 billion into the U.S. affiliate's operations.<sup>963</sup> It was claimed that HSBC knowingly and willingly evaded government safeguards intended to block terrorist funding, allowing affiliates to shield the fact that thousands of transactions involved links to Iran.<sup>964</sup> An independent audit paid for by HSBC discovered the bank facilitated 25,000 questionable transactions with Iran between 2001 and 2007.<sup>965</sup> The report also detailed that HSBC "worked extensively with Saudi Arabia's Al Rajhi Bank, some owners of which have been linked to terrorism financing."<sup>966</sup> HSBC's U.S. affiliate "supplied Al Rajhi with nearly \$1 billion worth of U.S. banknotes up to 2010," and "worked with two banks in Bangladesh ... linked to terrorism financing."<sup>967</sup>

In Senate hearings, HSBC executives admitted to failing to comply with legal requirements to prevent money laundering.<sup>968</sup> Mexico's National Banking and Securities Commission (CNBV) imposed a \$27.5 million fine against HSBC a week after the Senate report, the largest-ever handed out to a bank by the CNBV.<sup>969</sup> HSBC set aside \$700 million to cover the potential fines, settlements, and other expenses related to the AML investigations in the United States, a gross underestimation of the final payout.<sup>970</sup> The

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<sup>960</sup> Carrick Mollenkamp, Brett Wolf & Brian Grow, Special Report: Documents Allege HSBC Money-Laundering Lapses, REUTERS (May 3, 2012), <http://www.reuters.com/article/2012/05/03/ushsbcusaprobeseidUSBRE8420FX20120503>.

<sup>961</sup> 31 U.S.C. § 5311 (2001).

<sup>962</sup> 5 U.S.C. § 78dd-1 (1998).

<sup>963</sup> HSBC Report, *supra* note 15 (commenting that both U.S. and Mexican authorities warned that the amount of money could only be achieved through a link to narcotics trades).

<sup>964</sup> Mollenkamp, Wolf & Grow, *supra* note 960.

<sup>965</sup> HSBC Report, *supra* note 15.

<sup>966</sup> James O'Toole, HSBC Lax in Preventing Money Laundering by Cartels, Terrorists, CNNMoney (July 17, 2012), <http://money.cnn.com/2012/07/16/news/companies/hsbc-moneylaundering/index.htm>.

<sup>967</sup> *Ibid.*

<sup>968</sup> Jon Li, HSBC Money Laundering: David Bagley Resigns, Senator Grills Christopher Lok, The Finance Pages (July 18, 2012), <http://www.thefinancepages.co.uk/companies/hsbc-david-bagleyresigns/01713>.

<sup>969</sup> Dave Graham, HSBC Mexico Chief Says Fine Concludes Money-Laundering Probe, REUTERS (July 26, 2012), <http://www.reuters.com/article/2012/07/26/us-hsbc-mexico-idUSBRE86P0XM20120726>.

<sup>970</sup> Neil Gough, HSBC Sets Aside \$2 Billion for Legal Woes as Profit Falls, N.Y. Times Deal book (July 30, 2012), <http://dealbook.nytimes.com/2012/07/30/hsbc-sets-aside-2-billion-forlegalwoes-as-profit-falls/>.

worldwide failure of compliance and oversight indicates deep structural issues with HSBC's core business model.

### **Standard Chartered**

Standard Chartered was one of the few banks who emerged from the global financial crisis with its reputation undamaged.<sup>971</sup> However, in August 2012, the New York Department of Financial Services (DFS) alleged that Standard Chartered had caused the U.S. financial system to be “vulnerable to terrorists, weapons dealers, drug kingpins and corrupt regimes,” due to its relationships with Iranian Banks.<sup>972</sup> According to DFS, Standard Chartered helped enable U.S. dollar transactions worth about \$250 billion on behalf of its Iranian clients, “which generated hundreds of millions of dollars in fees” for the bank.<sup>973</sup> DFS was able to issue its claim based on over 30,000 pages of documentation, including emails that detailed wilful and egregious violations of the law.<sup>974</sup> The investigation led to several unanswered questions, however, and raised concerns regarding how the investigation was carried out and handled. The order provoked a harsh public response from Standard Chartered as well.<sup>975</sup> In a released statement, the London-headquartered bank stated it “strongly rejects the position or the portrayal of the facts as set out in the order issued by the DFS.”<sup>976</sup> The case was interesting not only in the issue of AML violations, but also the manner the investigation was handled given DFS acted on its sole accord, initiating strong criticism that DFS had acted outside of its authority.<sup>977</sup>

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<sup>971</sup> Justin O'Brien & Olivia Dixon, *The Common Link in Failures and Scandals at the World's Leading Banks*, 36 SEATTLE U. L. REV. 941, 960 (2013).

<sup>972</sup> Order Pursuant to Banking Law § 39, Standard Chartered Bank 1 (N.Y. Dep't of Fin. Servs. Aug. 6, 2012), available at <http://www.dfs.ny.gov/banking/ea120806.pdf>.

<sup>973</sup> *Ibid.* (alleging the behavior was conducted from 2001 to 2010).

<sup>974</sup> *Ibid.*

<sup>975</sup> Press Release, Standard Chartered Bank PLC, Standard Chartered PLC Strongly Rejects the Position and Portrayal of Facts Made by the New York State Department of Financial Services (Aug. 6, 2012), available at <http://www.standardchartered.com/en/news-and-media/news/global/2012-08-06-response-to-NY-State-Department-comments.html>.

<sup>976</sup> *Ibid.* (arguing that the history of the claims should indicate that at the time none of the account holders were designated a terrorist entity or organization).

<sup>977</sup> Mark Gongloff, ‘Rogue’ New York Regulator Benjamin Lawsky Sets Feds Scrambling in Standard Chartered Laundering Case, HUFFINGTON POST (Aug. 10, 2012), [http://www.huffingtonpost.com/mark-gongloff/benjamin-lawsky-standard-chartered-laundering\\_b\\_1765479.html](http://www.huffingtonpost.com/mark-gongloff/benjamin-lawsky-standard-chartered-laundering_b_1765479.html); Nils Pratley, Standard Chartered: Rogue Bank or Victim of Renegade Regulator? Guardian (Aug. 7, 2012) <http://www.guardian.co.uk/business/2012/aug/07/standard-charteredroguebank-or-victim>.

Standard Chartered also argued that “[r]esolution of such matters normally proceeds through a coordinated approach by such agencies. The Group was therefore surprised to receive the order from the DFS, given that discussions with the agencies were ongoing. “We intend to discuss these matters with the DFS and to contest their position.”<sup>978</sup> Nevertheless, the bank agreed to settle the matter for \$340 million, the highest ever for an AML violation by an individual regulator.<sup>979</sup> Standard Chartered also agreed to hire staff to oversee and audit offshore money laundering due diligence and monitoring while also agreeing to appoint an external monitor to be assessed by the DFS.<sup>980</sup>

## Conclusion

The practical and conceptual foundations of financial regulations are being tested continuously. Compliance, although it is said to be at the forefront of financial institutions is failing to be adhered to. Recent scandals demonstrate that there is a deficiency in ethical behaviour and lack of compliance in the culture of banks. Policy makers around the world need to rethink, what is the purpose of regulation? Matters remain unclear, especially as there is further examination taking place and also examine not how to regulate, but why. Resolution of the issues that continue to appear requires the establishment of a common standard of what constitutes responsibility and simultaneous clarification of requisite accountability structures. Improved global integration allows for financial institutions to better manage risks on a global basis. The world is not functioning on national levels and compliance and oversight must address this.

Banks have made empty promises at congressional hearings before going on to commit further violations, with monetary fines written off as the cost of doing business.<sup>981</sup>

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<sup>978</sup> Press Release, Standard Chartered Bank PLC, *supra* note 975.

<sup>979</sup> Liz Rappaport, *Bank Settles Iran Money Case*, WALL ST. J. (Aug. 15, 2012), <http://online.wsj.com/article/SB10000872396390444318104577589380427559>

<sup>980</sup> Consent Order Under N.Y. Banking Law § 44, Standard Chartered Bank 1 (N.Y. State Dep't of Fin. Servs. Aug. 6, 2012).

<sup>981</sup> Mark Squillace, *Innovative Enforcement Mechanisms in the United States*, *Australian Inst. of Criminology*, [http://www.aic.gov.au/media\\_library/publications/proceedings/26/squill.pdf](http://www.aic.gov.au/media_library/publications/proceedings/26/squill.pdf)

Compliance or cultural problems within a bank, regardless of the seriousness, can be contained either by adoption of structural reform, by external oversight, or if needed, by closing its doors. Regulatory effectiveness cannot be vouchsafed simply by reforming the institutional structure. Regulatory rules can be transacted around as can be seen through the case studies and also how reverse money laundering can escape around legal requirements. Such banking scandals and the new policy issues demonstrates that it is unsustainable for regulation to be decided, implemented, and monitored at a national level. Global oversight has become an imperative to reduce the conflicts of interest that may create profitable industries but not socially beneficial ones.

A bank should also ensure that any outsourcing arrangements for their compliance department do not impend effective supervision by its supervisors. Regardless of the extent to which specific tasks of the compliance function are outsourced, the board of directors and senior management remain responsible for compliance by the bank with all applicable laws, rule and standards.<sup>982</sup> Therefore, banks and senior management is responsible for establishing a written compliance policy that contains the basic principles to be followed by management and staff, and explains the main processes by which compliance risks as to be identified and managed through all levels of the organization.<sup>983</sup>

Leaders of the world and organizations such as Basel Committee and FATF must work together to make mutually reinforcing structure in order to move into a compliance order that is taken seriously and yields the results needed. The Compliance function should, on a pro-active basis, identify, documents and assess the compliance risks associated with the bank's business activities, including the development of new products and business practices. The compliance programme should be risk based and subject to oversight by the head of compliance to ensure appropriate coverage across businesses and co-ordination among risk management functions.<sup>984</sup>

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<sup>982</sup> Compliance and the compliance function in banks. Bank of international Settlements' Report April 2005

<sup>983</sup> Ibid

<sup>984</sup> Ibid

A suitable example in banking compliance function is to examine in the next chapter the role of Islamic banking in and its possible contribution to stability, as the availability of Islamic finance continues to grow, it is essential to understand the vulnerabilities that are produced for Islamic banks with regard to financial crimes and review the means to combat the risks involved.

## CHAPTER 6

### ISLAMIC FINANCE AND ITS POSSIBLE CONTRIBUTION TO STABILITY

#### Introduction:

Over the years, Islamic finance has become one of the fastest growing markets in the financial system.<sup>985</sup> With more than 350 Islamic financial institutions all over the world, there has been an increasing demand for the products and services they provide.<sup>986</sup> With the demand increasing, many western conventional banks have even begun to offer Islamic banking options to offer *Shari'a* compliant products and services to Muslims and non-Muslims alike.<sup>987</sup> This chapter will provide an overview of the Islamic finance industry, as well as the legal framework behind Islamic banking.<sup>988</sup> The chapter will also discuss the legal and regulatory challenges to promote the development of Islamic banking and its current global engagement with International Financial Institutions mainly the World Bank and the IMF and its possible in promoting stability.<sup>989</sup>

#### What is Islamic Finance?

Islamic finance has its origins in Egypt, where the first modern experimental Islamic bank was undertaken in the 1960s.<sup>990</sup> “Islamic finance was born out of the ideals to Islamize Muslim societies and even to establish Islamic states based on the sharia.”<sup>991</sup>

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<sup>985</sup> Euro money Encyclopedia of Islamic Finance 171 (Aly Khorshid ed., 2009) [hereinafter Euro money Encyclopedia].

<sup>986</sup> Ibid.; see also Tasnim Nazeer, Euro money Encyclopedia of Islamic Finance *The Ultimate Islamic Finance Review 2011*, GLOBAL ISLAMIC FINANCE, Jan. 2012, at 14, available at [http://www.globalislamicfinancemagazine.com/?com=news\\_list&nid=2187](http://www.globalislamicfinancemagazine.com/?com=news_list&nid=2187) (finding the Islamic finance industry to be valued at \$1.14 trillion and growing at a rate of ten percent).

<sup>987</sup> Andreas Ernst, *Promoting Islamic Finance and Islamic Banking*, 56 RECHTSPOLITISCHES L. POL. F. 6 (2011) available at, [http://www.uni-trier.de/fileadmin/fb5/inst/IRP/Rechtspolitisches\\_Forum/56\\_Ernst\\_EBook\\_geschuetzt.pdf](http://www.uni-trier.de/fileadmin/fb5/inst/IRP/Rechtspolitisches_Forum/56_Ernst_EBook_geschuetzt.pdf) (noting that the fast growing market for Islamic finance has captured the attention of many Western banks). See e.g. A.U.F Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* 256-259 (Brown Walker ed., 2010) (discussing how the United Kingdom has amended its tax laws to accommodate Islamic finance).

<sup>988</sup> See *infra* discussion II.

<sup>989</sup> See *infra* discussion IV.

<sup>990</sup> Brian Kettell, *Introduction to Islamic Banking and Finance* xiii (2011) (discussing that the movement towards Islamic finance was initiated by Ahmad Elnaggar).

<sup>991</sup> Hans Visser, *Islamic Finance: Principle and Practice* 7, (Edward Elgar ed., 2nd ed. 2013)

It is distinguishable from conventional finance and banking in that it is based on Islamic law, or *Shari'a*, which is also known as Islamic jurisprudence.<sup>992</sup> The primary materials from which *Shari'a* is derived include, in order of significance, (1) the Holy Qur'an, (2) the Sunnah and hadith, (3) Ijm'a, and (4) Ijtihad and Qiyas.

The *Qur'an* is the main source of *Shari'a* as it contains the words of Allah as revealed to the Prophet Muhammad, which created Islam.<sup>993</sup> At the beginning, the Prophet Muhammad preached “for humility, generosity and belief in God,” and the Quranic commandments were revealed subsequently, a period that is viewed as a beginning of “substantive legislation.”<sup>994</sup> The text of the *Qur'an* was recorded and confirmed during the life of the Prophet Muhammad. Legal injunctions are scattered throughout the verses of the *Qur'an* and are not confined to any specific chapter.<sup>995</sup> By addressing itself to the conscience of an individual, the *Qur'an* attempts to use its narrative style convincingly. In doing so, the *Qur'an* expresses its “purpose, reason, objective, benefit, reward and advantage of its injunctions.”<sup>996</sup> However, while some of the Quranic expressions are definitive in their application and leave no room for further interpretation, some are open to multiple interpretations.<sup>997</sup> If the verses of the *Qur'an* do not help establish a firm interpretation, then guidance from other sources of *Shari'a* are utilized.

The *Sunnah* are the sayings and behaviours of the Prophet Muhammad (PBUH) based on the recordings, the *Hadith*, documented by his contemporaries and later followers via oral tradition.<sup>998</sup> The *Qur'an* declared the Prophetic traditions were to be followed.<sup>999</sup> Initially, the Prophet discouraged his companions from documenting his life and practice

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<sup>992</sup> Mohammad Amin El- Gamal, Overview of Islamic Finance 2 (2006) available at, <http://www.nzibo.com/IB2/Overview.pdf>.

<sup>993</sup> Kettell, *supra* note 990, at 14, 16.

<sup>994</sup> Wael B. Hallaq, the Origin and Evolution of Islamic Law 19-21 (2005).

<sup>995</sup> *See ibid.* at 30 (commenting that the injunctions include matters related to family law, inheritance, and criminal punishments).

<sup>996</sup> Mohammad Hashim, Principle of Islamic Jurisprudence 27 (3rd ed. 2003).

<sup>997</sup> *Ibid.*

<sup>998</sup> Kettell, *supra* note 990, at 19 (explaining that Hadith is the narration of the behavior of the Prophet and the Sunnah is the example or law that is derived from it).

<sup>999</sup> *Ibid.* at 63

as he wanted to ensure the word of God was separated from his own.<sup>1000</sup> Thus, the traditions of the Prophet were compiled more comprehensively after his death. As differences in the text and transmission arose from the Prophet's traditions, a scientific study began. The prophetic traditions consist of three categories in relation to the *Qur'an*. The Prophetic traditions confirm and reiterate, explain and clarify, or comprise independent rulings that are unable to be traced back to the *Qur'an*.<sup>1001</sup>

*Ijm'a* refers to when Islamic jurists reach a consensus on various Islamic matters; it is an organic process in which the personal views of jurists concludes in a universal acceptance on a particular opinion over time.<sup>1002</sup> The consensus is not directly revealed and the need for rational proof helps to unveil this source of Islamic law.<sup>1003</sup> Consensus advances from toleration of a variety of juristic opinions until the diversity of opinion merges into a consensus.<sup>1004</sup> Once the consensus is established, it becomes a binding authority itself and its reliance on the primary sources is no longer significant.<sup>1005</sup> A consensus once established cannot be repealed by another consensus.<sup>1006</sup> Although there is support for majority rule to establish a consensus, the popular view favors unanimous consensus of all jurists.<sup>1007</sup>

*Ijtihad* in Arabic literally means an effort or to exercise to arrive at one's own judgment.<sup>1008</sup> A feature of Islamic law is that it attempts to achieve harmony between the revealed sources and reasons. Analogical reasoning is the main method for achieving and maintaining this harmony.<sup>1009</sup> For this reason, Juristic reasoning has become one of the

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<sup>1000</sup> Kamali, *supra* note 996, at 77-78 (explaining the Prophet did not want to cause confusing about the text of the *Qur'an*).

<sup>1001</sup> *Ibid.* at 81.

<sup>1002</sup> Kettell, *supra* note 990, at 20, 39 (finding the reasons for the prohibition of *riba* to be that it is unjust, it corrupts society, it implies improper appropriation of other people's property, it results in negative economic growth, and it demeans and diminishes human personality).

<sup>1003</sup> Kamali *supra* note 996, at 228.

<sup>1004</sup> *Ibid.*

<sup>1005</sup> *See ibid.* at 236-44 (observing that the status of the consensus as a source is established using the primary sources).

<sup>1006</sup> *See id.* at 232, 235-36 (clarifying that although this is the majority rule, some scholars believe that creating constituents may repeal the consensus and establish a new one).

<sup>1007</sup> *See id.* at 234 (providing an overview of the qualifications jurists must possess to participate in the Consensus, such as, jurists must qualify as upright individuals, be clear of pernicious innovation and heresy, and be qualified to carry out *ijtihad*).

<sup>1008</sup> Kettell, *supra* note 990, at 21.

<sup>1009</sup> Kamali, *supra* note 996, at 468.



leading sources of Islamic law.<sup>1010</sup> Juristic reasoning is utilized to infer and extract meaning from the unclear text of revealed sources.<sup>1011</sup> The reasoning can be expressed as an analogical reasoning (*Qiyas*)<sup>1012</sup> or in general.

Islamic banks and financial institutions establish their objectives and operations on Islamic-ethical principles derived from the *Qur'an*<sup>1013</sup> and also the *Sunnah* (the word and tradition of the Prophet Muhammad).<sup>1014</sup> This means that the products and services provided must comply with the principles of Islam.<sup>1015</sup> Most Westerners simply consider Islamic banking as interest free banking.<sup>1016</sup> However, there is much more to the Islamic system of finance than just interest free products and services.<sup>1017</sup>

There are six key principles involved in Islamic banking. The first of which does entail the prohibition of interest (for which the Arabic term is *riba*) in all transactions.<sup>1018</sup> The *Qur'an* and the *Sunnah* both contain various verses which mention the prohibition of *riba*.<sup>1019</sup> In Islam, only a good loan (*qard al hassan*) is allowed.<sup>1020</sup> To be a “good loan” essentially requires the lender not to charge any interest or additional amount.<sup>1021</sup> Interest, according to Islamic economist is a theoretical concept that does not produce real growth of capital.<sup>1022</sup> It has been interpreted as a form of exploitation and

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<sup>1010</sup> See *ibid.* (discussing that the importance of *ijtihad* lies in the fact that it is a continuous process, and can evolve with the “changing conditions of the Muslim community in its aspirations to attain justice, salvation and truth”).

<sup>1011</sup> *Ibid.*

<sup>1012</sup> See Kettell, *supra* note 990, at 21 (Noting that *Qiyas* represent analogies or the analogical reasoning which extends the position of the *Shari'a* on one matter to a new one).

<sup>1013</sup> Kettell L, *supra* note 990, at 31.

<sup>1014</sup> Imtiaz A. Pervez, *Islamic Finance*, 5 *ARAB L.Q.* 259, 261 (1990).

<sup>1015</sup> *Ibid.*; see also Han Visser, *Islamic Finance; Principles and Practices* 30 (Edward Elgar ed., 2nd ed. 2013) (discussing that Islamic economics is based on rules that Muslims should follow).

<sup>1016</sup> Ali Adnan Ibrahim, *The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration*, 23 *AM. U. INT'L L. REV.* 661, 664 (2008).

<sup>1017</sup> Ibrahim Warde, *Islamic Finance in the Global Economy*, 1-2 (2000) (detailing the expansion of Islamic finance from fourteen centuries of practice).

<sup>1018</sup> See Kettell, *supra* note 990, at 32 (explaining that *riba* refers to an addition, no matter how slight, over the amount of the principal and covers both interest and usury).

<sup>1019</sup> *Islamic Finance: A Practical Guide* 10 (Rahail Ali ed., 2nd ed., 2014) [*Islamic Finance: A Practical Guide*].

<sup>1020</sup> Kettell, *supra* note 990, at 33.

<sup>1021</sup> *Ibid.*

<sup>1022</sup> Pervez, *supra* note 1014, at 263.

injustice and thus is contrary to Islamic principles of fairness and property rights.<sup>1023</sup> There are three types of *riba* that *Shari'a* scholars have identified: *riba al-jahiliya*, *riba al-fadl*, and *riba al-nasiya*.<sup>1024</sup> *Riba al-jahiliya* was derived from the *Qur'an* while the other two types were based on the *Sunnah*.<sup>1025</sup> *Riba al-jahiliya* would require the borrower to return more money than had been borrowed.<sup>1026</sup> *Riba al-fadl* has been described by *Shari'a* scholars as a hidden interest which involves the exchange of the same type of commodities, but in different quantities.<sup>1027</sup> Finally, *riba al-nasiya* involves the exchange of the same commodities in the same quantity; however there is a delayed delivery.<sup>1028</sup> Thus, *riba* in any form is strongly prohibited in Islamic Finance.<sup>1029</sup>

The second key principle in Islamic finance entails profit and loss sharing.<sup>1030</sup> Islamic banks must reconcile the entrepreneurial needs of operating as a business and the prohibition of *riba*.<sup>1031</sup> To remedy these interests, Islamic banking emphasizes a communal relationship between the banks and their clients.<sup>1032</sup> Thus, lenders share the losses and profits that occur from the enterprise for which money is lent out.<sup>1033</sup> At the beginning of the lending process, the bank and the client agree upon a ratio of the profit and loss to share.<sup>1034</sup> The banks, as a silent partner, supply the needed finances and the client would provide the necessary labor, which justifies the agreed upon risk sharing.<sup>1035</sup> This occurs

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<sup>1023</sup> See Kettell, supra note 990, at 32.

<sup>1024</sup> Islamic Finance: A Practical Guide supra note 1019, at 10.

<sup>1025</sup> Ibid.

<sup>1026</sup> Ibid.

<sup>1027</sup> Ibid.

<sup>1028</sup> See id. (noting that *riba al-nasiya* has been approved by *Shari'a* scholars in times of necessity).

<sup>1029</sup> Ibid.; see also, Muhammad Nejatullah Siddiqi, *banking Without Interest* 7 (1983) (finding the position permitting forms of interest as “defeatist”).

<sup>1030</sup> See Euro money Encyclopedia, supra note 985, at 28 (discussing that basic principle of Islamic banking is the sharing of profits and loss).

<sup>1031</sup> Islamic Banking and Finance in the European Union 114 (M. Fahim Khan & Mario Porzio eds., 2010).

<sup>1032</sup> See Haider Ala Hamoudi, *The Impossible, Highly Desired Islamic Bank*, 5 WM. & MARY BUS. L. REV. 105, 115 (2014) (detailing that since the inception of Islamic finance the ideal is to create a two-tiered silent partnership); see also Hajah Salma Latiff, *The Risk Profile of Mudaraba and Its Accounting Treatment*, in *Current Issues in Islamic Banking and finance: Resilient and Stability in the Present System* 61, 67 (Angelo M. Venardos ed., 2010) (“The bank establishes itself as an intermediary between the suppliers of the capital and the users of the fund who need the money as a source of capital. In its intermediary capacity, the bank invests the funds in perceived lucrative and profitable businesses”).

<sup>1033</sup> Ibid.

<sup>1034</sup> Ibid.

<sup>1035</sup> See Hamoudi, supra note 1032, at 115 (explaining that as the ventures earned or lost money, the banks’ portion of the benefits or losses is then distributed to its depositors).

because Islam encourages Muslims to invest their money and become partners with the bank rather than to become creditors.<sup>1036</sup> The key to this principle is that the financier is only entitled to gains if there is risk involved in which they also participate in.<sup>1037</sup> The result of this arrangement is that Islam encourages particular investments to benefit the community, ensuring productive enterprises.<sup>1038</sup>

Considering the above, risk sharing is critical to Islamic banking.<sup>1039</sup> Investments cannot be made unless there is some risk involved.<sup>1040</sup> This principle distinguishes conventional banks from Islamic banks. Conventional banks are assured to have a return on their investments based on the interest charged and the entrepreneurs bear all the risk.<sup>1041</sup> Under Islam, this distribution of risk is not allowed.<sup>1042</sup> Islamic banking also emphasizes productivity as opposed to credit-worthiness in order to comply with the profit and loss sharing principle.<sup>1043</sup> When an Islamic bank is preparing to extend a loan to a client, the major consideration is whether the enterprise will succeed and create a profit.<sup>1044</sup> Thus, the bank will examine the soundness of the venture, the business acumen, and the competence of the entrepreneur.<sup>1045</sup>

The third principle is the notion that it is not acceptable to make money from money.<sup>1046</sup> *Shari'a* allows money to be used as a medium of exchange, but believes that money itself does not have a value.<sup>1047</sup> Money is not viewed as actual capital, but rather as potential capital.<sup>1048</sup> This entails that money becomes actual capital only when it is invested

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<sup>1036</sup> Kettell, *supra* note 990, at 33

<sup>1037</sup> *Ibid.*

<sup>1038</sup> *See ibid.* (finding that the Islamic financial system emphasizes investments in order to stimulate the economy and to provide an incentive for entrepreneurs to maximize their efforts to succeed).

<sup>1039</sup> Kettell, *supra* note 990, at 34.

<sup>1040</sup> *Ibid.*

<sup>1041</sup> *Ibid.*

<sup>1042</sup> *Ibid.*

<sup>1043</sup> *See id.* (commenting that conventional banks are primarily concerned with the loan and interest being paid on time).

<sup>1044</sup> *Ibid.*

<sup>1045</sup> *Ibid.*

<sup>1046</sup> *Ibid.*

<sup>1047</sup> *See Ernst, supra* note 987, at 17; *see also Visser, supra* note 1015, at 30 (“Money cannot have an exchange value of its own, which otherwise would result in a price for money as the rate of interest. Money does not have a market and hence no conceptions of demand and supply linked to such endogenous money in Islam”).

<sup>1048</sup> Kettell, *supra* note 990, at 34.

in business.<sup>1049</sup> Money represents purchasing power and Muslims are encouraged to spend or invest money into productive activities.<sup>1050</sup> However, purchasing power cannot be used to generate more purchasing power unless it is used in the creation of goods and services.<sup>1051</sup> Money must also be asset-backed since it has no value itself.<sup>1052</sup>

*Shari'a* prohibits *gharar* (uncertainty, risk or speculation) in transactions and represents the fourth principle in Islamic finance.<sup>1053</sup> The prohibition of *gharar* is to prevent exploitation of the weak.<sup>1054</sup> However, it is impossible to be absolutely certain about everything for every transaction which is why *Shari'a* does permit minor uncertainty.<sup>1055</sup> Nevertheless, transactions will be invalidated when there is excessive uncertainty.<sup>1056</sup> Thus, commercial partners are supposed to know the counter value that is being offered in a transaction.<sup>1057</sup> Similar to the prohibition of *riba*, scholars argue that the prohibition of uncertainty protects investors from excessive financial exposure “or payment of mispriced premia to eliminate existing risks.”<sup>1058</sup>

The fifth key principle of Islamic banking is that only *Shari'a* compliant contracts may be utilized.<sup>1059</sup> Given that Islamic banking is based on the ethical system of Islam, all

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<sup>1049</sup> Ibid.

<sup>1050</sup> Ibid.

<sup>1051</sup> Ibid.

<sup>1052</sup> See Ernst, supra note 987, at 17 (discussing that parties to an agreement must link the finance to a tangible asset that is specified at the onset of the agreement).

<sup>1053</sup> Kettell, supra note 990, at 35; see Ibrahim, supra note 1016, at 701 (conveying that *gharar* includes lack of complete information, deceit, risk, and inherent uncertainty as to the subject matter of the contract).

<sup>1054</sup> Visser, supra note 991, at 54 (explaining that uncertainty generally includes lack of complete information, deceit, risk, and inherent uncertainty as to the subject matter of the contract).

<sup>1055</sup> Ibrahim, supra note 1016, at 701.

<sup>1056</sup> See Mohamoud A. El-Gamal, *Islamic Finance: law, Economics, and Practice* 58-59 (2006) (relaying four conditions that invalidate a contract). First, *gharar* must be excessive to invalidate a contract. Thus, minor uncertainty about an object of sale (e.g., if its weight is known only up to the nearest ounce) does not affect the contract. Second, the potentially affected contract must be a commutative financial contract (e.g., sales). Thus, giving a gift that is randomly determined (e.g., the catch of a diver) is valid, whereas selling the same item would be deemed invalid based on *gharar*.

Third, for *gharar* to invalidate a contract, it must affect the principal components thereof (e.g., the price or object of sale).

<sup>1057</sup> Visser, supra note 991, at 53.

<sup>1058</sup> See El-Gamal, supra note 1056, at 60-62 (describing empirical findings of contemporary behavioral finance literature to emphasize that “human idiosyncrasies” such as people's preference of risk-loving behavior over risk-and-loss averse behavior depend on how a “reference point” is presented to them, and also noting that a religious pre-commitment helps individuals to avoid financial detriments).

<sup>1059</sup> Kettell, supra note 990, at 35.

agents involved in a financial transaction must comply.<sup>1060</sup> Accordingly, no contract or financial involvement may be *haram* (forbidden).<sup>1061</sup> The final key principle in Islamic banking is the sanctity of contracts.<sup>1062</sup> The *Qur'ran* encourages trade and commerce so long as the transactions are legitimate trade and business.<sup>1063</sup> Islam requires more than the parties to a contract to keep true to the contractual provisions.<sup>1064</sup> Islam holds that personal property is inviolable and thus prohibits another from taking property through theft, embezzlement, bribery, other means of taking property and wealth.<sup>1065</sup> Additionally, every contract must ensure fairness and the welfare of all parties involved.<sup>1066</sup> Accordingly, the crucial elements of a contract are the form (offer and acceptance), the parties and the subject matter of the contract.<sup>1067</sup> Furthermore, a contract is only enforceable when there is mutual consent of all parties.<sup>1068</sup> Each party involved must also possess the appropriate knowledge of the subject matter and must have the legal capacity to enter into a contract.<sup>1069</sup>

### **The World Bank and The IMF's role on Islamic finance**

Many multilateral institutions share the consensus that Islamic finance may be useful to problems faced by developing countries. The World Bank has publicly expressed that Islamic Finance “has the potential to help address the challenges of ending extreme poverty and boosting shared prosperity” (World Bank 2015). It has demonstrated considerable commitment to the development of the Islamic financial services industry through its 2015 signing of memorandum of Understanding with the General Counsel for

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<sup>1060</sup> Ibid.

<sup>1061</sup> See *ibid.* (explaining that the principal business of a company must be in compliance with Shari'a which excludes companies involved in selling or offering alcohol products, pork, or forbidden meat, gambling, night club activities, pornography, and other haram goods or services that are determined to be harmful to society under Islam).

<sup>1062</sup> Ibid.

<sup>1063</sup> See *ibid.* (observing that Islam regulates both personal life and the conduct of business and commerce).

<sup>1064</sup> See *ibid.* (finding Islam supports contractual obligations and the release of information as a sacred duty); see also ISLAMIC FINANCE: A PRACTICAL GUIDE, supra note 1019, at 11.

<sup>1065</sup> Ibid.

<sup>1066</sup> Ibid.

<sup>1067</sup> See *ibid.* (noting that these elements are considered by Shari'a scholars to provide guidance and that the absence of any of these elements would render the contract null and void).

<sup>1068</sup> Ibid. (remarking that a contract is invalid when consent obtained through oppression, fraud, or misrepresentation).

<sup>1069</sup> Ibid.

Islamic Banks and Financial Institutions (CIBFI), the global alliance of the Islamic financial services industry, to strengthen institutional backing for the industry. The International Monetary Fund (IMF) has established an interdepartmental Working Group for analytical work on Islamic finance related to its key areas of supervision as well as an External Advisory Group of experts to assist in coordination with stakeholders. Not only IFSB, at the end of 2015 it also announced that it will integrate Islamic finance into its monitoring of financial sectors around the world. The IMF's initiatives reflect the institution's support for the credibility of Islamic finance as well as the general promotion among international organizations to harmonize standards for Islamic finance as it becomes increasingly absorbed into the mainstream global financial market.

Several examples already point to the success of Islamic Finance in non-Muslim countries. In June 2014, Britain became the first non-Muslim country to issue sukuk, the Islamic equivalent of a bond, with the 200 million (British Pound) sukuk offering attracting more than 2.3 billion (British Pound) in orders. Working with the Abu Dhabi Islamic Bank PJSC, the Dubai- Based Emirates NBD PJSC, and Qatar's QInvist LLC, Hong Kong Monetary Authority followed with its own issuance in September 2014. The \$1 billion sale attracted more than \$4.7 billion in order, with an estimated two-thirds of total orders from outside the Muslim world. The product offered was appealing for clear reasons: the five-year-dollar-dominated asset at 2.005% was 23 basis points above five-year US treasuries (The Economist 2014). The sale was financially remarkable as it was politically symbolic of China's entrance into Islamic financial market.

### **The Legal Framework of Islamic Banking**

The framework of Islamic financial institutions in various jurisdictions represents the diverse practices and models of the *Shari'a* governance systems. While some jurisdictions prefer greater involvement of regulatory authorities, other jurisdictions prefer less involvement.<sup>1070</sup> It is also inevitable that legal obstacles will arise when it comes to

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<sup>1070</sup> Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at United Kingdom and Malaysia*, 124 (2011) (contending that the subject of banking regulation is

the accommodation of *Shari'a* law with a country's secular legal system, which is often based upon European Common Law.<sup>1071</sup> Even despite whether a country is based on a secular legal system or not, another issue with regards to the legal framework of Islamic banks is that some countries, and/or particular Islamic banks, authorize the use of all of the above mentioned products and services while others are more restrictive.<sup>1072</sup> Such practices create irregularities and different thoughts as to what is acceptable among countries and banks.<sup>1073</sup>

Islamic financing has found a niche within the modern financial complex, but its growth has not been accompanied by a coherent body of governing rules “native to the Islamic intellectual perspective.”<sup>1074</sup> Furthermore, *Shari'a* law has not been allowed to be practiced fully in any western country.<sup>1075</sup> In the United Kingdom, *Shari'a* has been integrated into two areas of British law: food regulations (e.g. allowing meat to be slaughtered according to Islamic practices) and finances, where the Treasury has integrated *Shari'a*-compliant financial products such as mortgages and investments.<sup>1076</sup> In Southeast Asia, it has become a matter of individual state legal policy as to how to incorporate *Shari'a* law and secular state legal systems.<sup>1077</sup> Although it is up to each state to determine Islam's influence on their legal system, it appears that the states are often influenced by the current, and projected, size of the state's Muslim population.<sup>1078</sup>

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controversial although the need for such regulation is not); Zulkifli Hasan, Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK, 3 KYOTO BULL. OF ISLAMIC AREA STUD. 82, 83 (2010) available at [http://www.asafas.kyoto-u.ac.jp/kias/1st\\_period/contents/pdf/kb3\\_2/07zulkifli.pdf](http://www.asafas.kyoto-u.ac.jp/kias/1st_period/contents/pdf/kb3_2/07zulkifli.pdf) (observing that there is no consensus as to which approach to governance is more appropriate).

<sup>1071</sup> Kylee R. Sargenti, The Growth of Islamic Banking: A Singaporean Study on the Legal Conflicts of Embracing Shari'ah Law, 8 SANTA CLARA J. INT'L L. 431, 441 (2010).

<sup>1072</sup> Kelly Holden, Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern, 25 B.U. INT'L L.J. 341, 352 (2007).

<sup>1073</sup> *Ibid.*

<sup>1074</sup> Holden, *supra* note 1072, at 362.

<sup>1075</sup> *See* Sargenti, *supra* note 250, at 438 (noting that Canada has come close to permitting full practice of Shari'a law).

<sup>1076</sup> *Ibid.*

<sup>1077</sup> *Ibid.*

<sup>1078</sup> *Ibid.*

As mentioned above, to ensure conformity with *Shari'a* law and that Islamic beliefs are implemented, *Shari'a* Supervisory Boards (“SSB” or “board”) are mandatory in Islamic financial institutions.<sup>1079</sup> The SSBs have three central functions that must be carried out. First, to ensure that the banking facilities and services offered are in accordance with Islam.<sup>1080</sup> Second, is to guarantee that the bank’s investments and involvement in projects are *Shari'a* –compliant.<sup>1081</sup> Lastly, the SSB is to ensure that the bank is managed in concordance with Islamic values.<sup>1082</sup>

The board is an independent body of experts knowledgeable in *fiqh al-muamalat* (Islamic rules on transactions) and entrusted with the duty of directing, reviewing and supervising the activities of Islamic financial institutions to insure *Shari'a* compliance.<sup>1083</sup> The board reports to and is accountable for the management of Islamic financial institutions.<sup>1084</sup> Consequently, *Shari'a* governance adopts a two-tier system consisting of the management board which handles the affairs of Islamic financial institutions, similar to a conventional board of directors in any corporation, and the *Shari'a* board which reviews transactions and actions of Islamic financial institutions to ensure their adherence to Islamic law.<sup>1085</sup>

It is the board’s responsibility to work with management to ensure that all matters relating to the financial products or service are in compliance with the principles and guidelines of the *Shari'a* and, just as important, to ensure that there is sufficient transparency in the *Shari'a* process so that the product or service is understood by consumers or investors to be *Shari'a*-compliant. In carrying out its responsibilities, the *Shari'a* board needs a clear framework and structure to ensure its independence and effectiveness. Thus, *Shari'a* governance can be defined as a set of organizational arrangements concerning how the *Shari'a* board is directed, managed, governed, and

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<sup>1079</sup> Kettell, *supra* note 990, at 25.

<sup>1080</sup> *Ibid.*

<sup>1081</sup> *Ibid.*

<sup>1082</sup> *Ibid.*

<sup>1083</sup> Yousuf Al Qaraddawi, *The Governing Rules of Transaction’s Jurisprudence* 15-22 (2010).

<sup>1084</sup> *Ibid.*

<sup>1085</sup> Bashar H. Malkawi, *Shari'ah Board in the Governance Structure of Islamic Financial Institutions*, 61 *AM. J. COMP. L.* 539, 543 (2013).



controlled.<sup>1086</sup> In comparison to the conventional concept of corporate governance, *Shari'a* governance is considered unique in its financial architecture, as it is concerned with the religious aspects of the overall activities of its financial institutions.<sup>1087</sup> The role of the *Shari'a* board may vary from one institution to another, depending upon the nature, extent, and degree of *Shari'a* compliance. Nevertheless, the *Shari'a* board owes a fiduciary duty to all stakeholders involved in the financial institution.<sup>1088</sup> Additionally, an Islamic financial institution's integrity depends largely on the status of *Shari'a* compliance, its impact of products, professional competence, and behavior towards, and observance of *Shari'a* norms.<sup>1089</sup> Accordingly, the *Shari'a* board can play an essential role in ensuring and enhancing the credibility of the Islamic financial institutes.<sup>1090</sup>

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<sup>1086</sup> Mohammed Al-Sanosi, *The Concept of Corporate Governance in Shari'a*, 20 *European B. L. REV.* 343, 448 (2009).

<sup>1087</sup> In the conventional system of corporate governance, the primary objective of the company is to make a profit and increase shareholder wealth. Accordingly, a non-shareholder manager often has no incentive to take risk, since they know that if the company fails they will lose their position. See Allison Dabbs Garrett, *Themes and Variations: The Convergence of Corporate Governance Practices in Major World Markets*, 32 *DENV. J. INT'L L. & POL'Y* 147, 148 (2004). For banks, the Basel Committee issued a revision to its 1999 guidance in 2006 which set forth eight principles by which sound banks are governed. These principles are: 1: Board members should be qualified for their positions, have a clear understanding of their role in corporate governance, and be able to exercise sound judgment about the affairs of the bank. 2: The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organization. 3: The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization. 4: The board should ensure that there is appropriate oversight by senior management consistent with board policy. 5: The board and senior management should effectively utilize the work conducted by the internal audit function, external auditors, and internal control functions. 6: The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment. 7: The bank should be governed in a transparent manner. 8: The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures that impede transparency. See Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organizations* 6-17 (2006), available at <http://www.bis.org/publ/bcbs122.pdf>.

<sup>1088</sup> Muhammad Ayub, *Understanding Islamic Finance*, 465 (2007). See Masudul A. Choudhury & Mohammad Z. Hoque, *an advanced Exposition of Islamic Economics and Finance* 57-58, 85-88(2004) (noting that *Shari'a* corporate governance is based on the principle of Tawhid which is considered the foundation of Islam, i.e., the oneness of Allah (God). The principle of Tawhid includes the concept of vicegerency (khilafah), and justice (al-adl). The stakeholders as vicegerent of Allah have fiduciary duty to uphold the principles of Islamic law through direct participation in the affairs of the corporation or through representatives. There are two institutions involved in the process of *Shari'a* corporate governance, namely, the *Shari'a* board and stakeholders. The *Shari'a* board ensures that all IFIs activities are in harmony with Islamic law while stakeholders play an active role in decision making by taking into account the interests of all rather than profit-maximization for shareholders only).

<sup>1089</sup> *Ibid.* at 467.

<sup>1090</sup> *Ibid.*

While the *Shari'a* Supervisory Boards ensure that the Islamic financial institutions are correctly handling their services and products, in the majority of cases, Islamic banks still remain under the authority of conventional banking systems.<sup>1091</sup> This requires that before any financial transaction is completed, it must undergo double scrutiny: first, to ensure *Shari'a* compliance and second, to ensure that it complies with the national legal and regulatory requirements where the bank is located.<sup>1092</sup> To comply with both, *Shari'a* scholars trained in *fiqh muamalat*, the branch of Islamic law that is concerned with worldly transactions and everyday living, work with commercial law lawyers. All Islamic financial institutions are established under national laws and the financial products rendered are governed by these laws. There are no international laws pertaining to Islamic finance or any other type of finance, however there are regulatory standards which most national regulatory bodies adhere to in order to ensure that the institutions they regulate are viewed by foreign financial institutions as creditworthy counterparts.<sup>1093</sup>

In the United Kingdom, which has had success in Islamic finance, any financial institution seeking to provide Islamic banking services and products must apply for a license under the Financial Services and Market Act of 2000 ("FSMA").<sup>1094</sup> The FSMA covers the regulatory framework and the licensing requirements for all financial service activity as there is no separate legislation for the registration of Islamic financial services.<sup>1095</sup> In order to obtain authorization to conduct business, an Islamic financial institution has to be incorporated as a company in the United Kingdom and have its head of office and senior management in the country.<sup>1096</sup> Further, it must also have adequate resources for the business it seeks to undertake and the management must fulfill the proper criteria, particularly it must be able to undertake the business in a sound and proper manner

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<sup>1091</sup> See Rodney Wilson, Legal, Regulatory and Governance Issues in Islamic Finance 103 103 (2012).

<sup>1092</sup> Ibid. at 17.

<sup>1093</sup> "Basel III" is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. See Basel Committee on Banking Supervision, Bank for International Settlements, International Regulatory Framework for Banks, available at <http://www.bis.org/bcbs/basel3.htm>

<sup>1094</sup> Wilson, *supra* note 270, at 115.

<sup>1095</sup> Michal Ainley Et Al., Islamic Finance in the UK: Regulation and Challenges 10-15 (2007).

<sup>1096</sup> Ibid.

without dependence on outsiders whose interests are not declared.<sup>1097</sup> The reasons for the success of Islamic banking in the United Kingdom include: (1) the sophisticated market and skill base in London in terms of legal, accounting, and financial expertise; (2) a preference for Anglo-Saxon common law in Islamic financial transactions;<sup>1098</sup> (3) public policy and taxation changes; and (4) the United Kingdom's switch to a single financial regulator, the Financial Conduct Authority (“FCA”).<sup>1099</sup>

The applicant should also consult with the FCA about the products they intend to offer so that the proper regulatory requirements are determined. Islamic banks are not exempted from regulations that cover aspects such as deposit-protection insurance and they must contribute to the Financial Services Protection Scheme, in which bank deposits up to a certain amount are fully protected.<sup>1100</sup> For *mudaraba* investment account holders, the guarantee must be offered, but they can sign waivers indicating that they do not require protection so that their deposit contracts remain in compliance *Shari'a* law.<sup>1101</sup>

The FCA as a secular authority and is not concerned with *Shari'a* compliance. The FCA is interested only in the interests of customer protection and they require assurance that if the products and services being offered are *Shari'a* compliant, that there should be some creditable system in place to ensure that this is the case, hence the requirement of *Shari'a* Supervisory Boards. The FCA also concerns itself with the promotional and marketing material that Islamic financial institutions employ.<sup>1102</sup> The FCA requires that this material be clear, fair, and not misleading. Given the complexity of many Islamic

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<sup>1097</sup> Ibid.

<sup>1098</sup> See, e.g., *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd*, [2004] EWCA (Civ) 19 (presenting an Islamic finance contract that cited both *Shari'a* and English law in its choice of law clause).

<sup>1099</sup> See Mushfique Shams Billah, *Arab Money: Why Isn't the United States Getting Any?*, 32 U. PA. J. INT'L L. 1055, 1079 (2011) (noting that the United Kingdom's advantageous legal and regulatory environment has attracted several powerhouse Islamic financial institutions and mainstream Islamic windows, including, but not limited to, HSBC Amanah, Lloyds TSB, the United Bank of Kuwait, the Islamic Bank of Britain, Gatehouse Bank, Investment Dar, Barclays, Citibank, Kuwait Finance House, Samba Financial Group, and European Islamic Investment Bank).

<sup>1100</sup> Ainley et al., *supra* note 274, at 11.

<sup>1101</sup> Ibid.

<sup>1102</sup> Ibid.

financial products and the misunderstandings of some clients and potential clients, it is particularly important for FCA.

Unlike the United Kingdom who has adopted the “no obstacles, but no favours” approach to Islamic finance, enabling its growth in London, the United States has only stated this position without implementing it.<sup>1103</sup> The First Vice President of the Federal Reserve Bank of New York proclaimed, “Islamic bankers have been quite ingenious in developing financial transactions that suit their needs: we bank supervisors, too, can be ingenious and will want to work with any of you should you decide that you want to engage in Islamic banking in the United States.”<sup>1104</sup> Although such proclamations are encouraging, the United States government has done little in attempting to remove the main regulatory obstacles that are preventing Islamic financial institutions from prospering in the United States. That is why there are as few as only nineteen providers of Islamic financial products in the United States, none of which is a full-fledged Islamic commercial bank like the Islamic Bank of Britain.<sup>1105</sup>

### **Risk and Regulatory Issues**

The specific criteria for Sharia compliance necessitates a set of risks for Islamic finance, in addition to the standard risks associated with banking activities such as credit, market, liquidity, operational, regulatory, and legal risks. In particular, there are risks related to the business model and emerging state of the industry. Some of these risks

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<sup>1103</sup> Ibid.

<sup>1104</sup> Ernest T. Patrikis, First Vice President Fed. Reserve Bank of N.Y., *Islamic Finance in the United States--The Regulatory Framework*, Remarks before the Islamic Finance and Investment Conference (May 23, 1996) (transcript available at [http://www.ny.frb.org/newsevents/speeches\\_archive/1996/ep960523.html](http://www.ny.frb.org/newsevents/speeches_archive/1996/ep960523.html)). Furthermore, in May 2004, the Under Secretary of the U.S. Treasury focused on regulating domestic Islamic banks in a public address, “[W]e need to deepen our understanding and awareness of Islamic finance, to protect its unique role, to honor its tradition, and to ensure sound regulatory frameworks and suitable jurisprudence that allow for efficient financial intermediation.” John B. Taylor, Under Sec’y of the Treasury *Understanding and Supporting Islamic Finance: Product Differentiation and International Standards*, Keynote Address at the Forum on Islamic Finance, Harvard University (May 8, 2004) (transcript available at <http://www.treasury.gov/press-center/press-releases/Pages/js1543.aspx>). Also, in 2008, U.S. Treasury Department Deputy Secretary Robert Kimmit made a trip to the Middle East where he “publicly expressed the U.S.’s positive and accommodating attitude towards the development and growth of the industry in the country.”

<sup>1105</sup> Abdi Shayesteh, *Islamic Banks in the United States: Breaking Through the Barriers*, 171 NEW HORIZON 1, 1 (2009), available at <http://www.kslaw.com/people/pdfbio?id=330374>.

include equity investment risk sharing from profit-and loss-sharing financial instruments and liquidity risk heightened by limited number of Sharia compliant financial instruments and lack of lender of last resort facility. Demand for Islamic financial products continues to exceed supply, leading to oversubscribed sukuk. In addition, the requirement for investments to be backed by tangible assets has precipitated complex transactions as well as corporate structures that incorporate non-financial corporations. In sum, as identified by European Central Bank, the obstacles of Islamic finance are not few, including insufficient standardization, a shortage of liquidity and small size of issuances, the inadequate number of high quality issuers, and the tendency to focus only on domestic market.

In most jurisdictions, Islamic banks coexist with conventional banks, both of whom compete for clients. Despite the growth in Islamic banking, these banks usually only account for a limited share of total bank deposits or total bank assets, often less than ten percent of the total.<sup>1106</sup> A consequence of Islamic banks holding a minority share of the market is that they will often follow existing banking models and process, becoming market followers rather than market leaders.<sup>1107</sup> Furthermore, many scholars and commentators have pointed to numerous issues with the current manner Islamic finance is structured within conventional banking systems.<sup>1108</sup> Lack of standardization also effects the development of Islamic financial institutions.<sup>1109</sup> Islamic banking practices do not have a clear policy on what is allowed and what is not allowed. *Shari'a* board in one country may permit a particular practice while in another country it is not. Even regulations regarding *Shari'a* boards may differ between countries.<sup>1110</sup> Along those lines, some Islamic banks follow International Accounting Standards, others may adhere to standards issued

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<sup>1106</sup> See Wilson, *supra* note 1091, at 89 (finding that there is no market in which conventional banks operate where an Islamic bank is the market leader).

<sup>1107</sup> *Ibid.*

<sup>1108</sup> Oliver Agha, *Islamic Finance in the Gulf: A Practitioner's Perspective*, 1 Berkeley J. Middle E. & Islamic L. 179, 182 (2008). (“[U]ncertainty is considered a problem under Islamic Finance.”); Kilian Bälz, *Islamic Finance for European Muslims: The Diversity Management of Shari’ah-Compliant Transactions*, 7 CHI. J. INT’L L. 551, 556 (2007) (“[F]or centuries, the Islamic Shari’ah has been a discursive legal system with a fair degree of pluralism (or uncertainty) in terms of black letter rules.”); 129-31 (Clement M. Henry & Rodney Wilson eds., 2004) (relaying the removal of capital from Islamic countries due to the structure of Islamic finance).

<sup>1109</sup> Euromoney Encyclopedia, *supra* note 1, at 176.

<sup>1110</sup> *Ibid.*

by the Accounting Auditing Organization for Islamic Financial Institutions, and while small Islamic banks may just rely on local market standards. However, regulators who take time to understand the markets and the willingness of institutions to enter into new markets can lead to regulatory harmony on many of the standardization issues.

Most adaptations for Islamic financial institutions to function are done at the regulatory level rather than through legislation. Legislation to accommodate Islamic banking is more politically controversial, and thus faces difficult obstacles in passing. Regulatory changes are more technical in nature and often prove easier to pass through.<sup>1111</sup> When deregulation began to take place before the financial crisis, Islamic banks were able to benefit a little more as it was easier to introduce various deposits and financing instruments without too many questions being asked.<sup>1112</sup> However, as tighter scrutiny began again, there was less willingness to change the status quo. Since 2008, the move to tighter regulation poses several challenges for Islamic banks which could lead to discouragement and lack of innovation.<sup>1113</sup> The FCA in the United Kingdom takes a keen interest in what financial products are offered, but there has been less interest at the regulatory level in the Gulf Cooperation Council (“GCC”). Financial regulators have two objectives.<sup>1114</sup> First, they are concerned with that the financial institutions they regulate remain solvent. Second, they are concerned that the clients of the financial institutions have access to relevant information so that they are able to effectively manage their financial affairs. Although the latter refers to financial product information, regulators take more interest in the former objective. Remaining solvent means maintaining adequate liquidity, which poses a problem for Islamic banks which cannot hold interest bearing treasury bills or maintain deposits with central banks that pay interest.<sup>1115</sup> The social and political climates in some countries obviously pose another hindrance on the development of Islamic banks when they are unable to break through the political and social perceptions.<sup>1116</sup>

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<sup>1111</sup> Ibid.

<sup>1112</sup> Ibid.

<sup>1113</sup> Ibid.

<sup>1114</sup> Ibid.

<sup>1115</sup> Ibid.

<sup>1116</sup> Euromoney Encyclopedia, *supra* note 1, at 176.

The United States' regulatory system provides several hurdles for Islamic banks to overcome in order to develop a financial system there. For instance, under the Bank Holding Company Act ("BHCA"), given certain exceptions,<sup>1117</sup> a "bank" is defined either as an institution, whose deposits are insured by the Federal Deposit Insurance Corporation ("FDIC"),<sup>1118</sup> or:

An institution organized under the laws of the United States, any State of the United States, the District of Columbia, and any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands which both--

- (i) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and
- (ii) is engaged in the business of making commercial loans.<sup>1119</sup> As can be seen from the above definition, the term "bank" does not apply to a bank organized outside the United States. In such foreign contexts, as often is the case with Islamic banks, the International Banking Act ("IBA") applies.<sup>1120</sup>

Thus, regardless of which part of the regulations are examined, to be a bank within the United States relies on deposits. The U.S. does not allow initial deposits to be at risk and so they must be insured by the FDIC up to a specified limit.<sup>1121</sup> This can prove problematic for Islamic banks given that, in order to be compliant with *Shari'a*, deposit accounts are based on a profit-loss sharing system, an arrangement that puts the initial deposit at risk. As such, the U.S. statutory definition of deposit poses a potential obstacle to Islamic banking.<sup>1122</sup>

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<sup>1117</sup> See Bank Holding Company Act 12 U.S.C. § 1841(c)(2) (2006) (providing exceptions, such as foreign banks and insured bonds).

<sup>1118</sup> See *id.* (referencing the Federal Deposit Insurance Act under 12 U.S.C. § 1813(h) which provides further definitions of a bank, all of which rely on deposits).

<sup>1119</sup> *Ibid.* at § 1841(c)(1)(B) (2006).

<sup>1120</sup> See Banks and Banking, 12 U.S.C. §§ 3101-07 (2006) ("For the purposes of this chapter the term 'foreign bank' includes, without limitation, foreign commercial banks, foreign merchant banks and other foreign institutions that engage in banking activities usual in connection with the business of banking in the countries where such foreign institutions are organized or operating.").

<sup>1121</sup> See 12 U.S.C. § 1813(l) (2006) (defining "deposit" under the BHCA).

<sup>1122</sup> Isam Salah, Legal Issue Arising in Islamic Finance Transactions in The United States, In Islamic Finance North America 61 (2009) (detailing the obstacles to Islamic retail investment products in the United States).

The National Bank Act of 1864<sup>1123</sup> (“NBA”) also proves to be a regulatory hurdle for Islamic banks. The NBA prohibits commercial banks from purchasing, holding legal title, or possessing real estate to secure any debts to it for a period exceeding five years. Such a prohibition hinders Islamic financial products used by clients for purchasing goods, such as *murabaha* contracts. However, in two interpretive letters, 806 and 867, the Office of the Comptroller of the Currency (“OCC”) concluded that particular versions of *murabaha* and *ijara* contracts would be considered exceptions to the NBA rule if they meet the standards for functional equivalence to conventional asset financing.<sup>1124</sup> Accordingly, although regulatory obstacles exist, there are signs that bankers and U.S. government regulators are willing to work on becoming more accommodating.

In the United Kingdom, there is increasing flexibility in dealing with regulatory hurdles which allows Islamic banks to flourish more easily.<sup>1125</sup> The Financial Services Authority adheres to principles which encourage “facilitating innovation and avoiding unnecessary barriers to entry or expansion within the financial markets.”<sup>1126</sup> This enables U.K. regulatory officials and policymakers to be more equipped with regulating new financial products with greater flexibility than their American counterparts. For instance, although United Kingdom is similar to the U.S. in that a “customer is assured full repayment [of his deposit] as long as the bank remains solvent,” a customer has the option to turn down deposit protection on religious grounds.<sup>1127</sup> As an alternative, customers could choose to be repaid under the *Shari'a*-compliant profit sharing and loss bearing formula. The Islamic financial system has several regulatory bodies that oversee it, interpret *Shari'a* law, and issue recommendations, *fatwas*, and other forms of guidance on how to invest in accordance with the will of Allah. Some commentators have also argued that this system

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<sup>1123</sup> 12 U.S.C. §§ 21-216d (2006).

<sup>1124</sup> See Shirley Chiu et al., *Islamic Finance in the United States: A Small but Growing Industry*, 214 Chicago Fed Letter (2005) (noting that 1) the underwriting standard used in these models must incur the same risks as that of a conventional loan; 2) the risk incurred by the bank if a customer defaults on payments must be the same as that of a conventional loan; and 3) the risk from the bank's holding of legal title to the property must be the same as that of a bank providing a conventional loan).

<sup>1125</sup> See Michael Ainley et al., *Islamic Finance in the UK: Regulation and Challenges*, financial Services Authority 14 (2007).

<sup>1126</sup> *Ibid.*

<sup>1127</sup> *Ibid.*



has stalled the growth and advancement of Islamic finance and its adaptation to modern conventions and has led to fragmentation.

There are several regulating bodies which have developed to specifically regulate Islamic banking. The Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”) passes guidelines and regulates Islamic financial systems internationally. AAOIFI is arguably one of the most important regulating bodies. Founded in 1991, the AAOIFI describes its role as “an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and *Shari'a* standards for Islamic financial institutions and the industry.”<sup>1128</sup> Seven countries have adopted and implemented the AAOIFI’s standards, and six others have issued guidelines and laws based on the AAOIFI’s standards.<sup>1129</sup> AAOIFI does not develop products to be issued; it merely establishes the framework within which products can be developed. Additionally, even institutions that heavily rely on the AAOIFI will typically also retain an internal or external *Shari'a* board that supervises compliance with these principles. As a result, standardization in the manner carried out by the AAOIFI may help provide some guidance, but it will not solve the problems encountered when structuring a concrete product.<sup>1130</sup>

The Islamic Financial Services Board (“IFSB”), found in Malaysia, is “an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.”<sup>1131</sup> The IFSB publishes standards and other regulatory documents to aid in guiding institutions and countries in developing *Shari'a* compliant banking.<sup>1132</sup>

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<sup>1128</sup> Accounting & Auditing Org. for Islamic Fin. Insts., AAOIFI Overview, *available at* <http://www.aoifi.com/overview.html>.

<sup>1129</sup> *See id.* (listing implementation of AAOIFI standards in Bahrain, Jordan, Lebanon, Qatar, Sudan, Syria, and Dubai International Financial Centre, and of AAOIFI-based guidelines in Australia, Indonesia, Malaysia, Pakistan, Saudi Arabia, and South Africa).

<sup>1130</sup> *Ibid.*

<sup>1131</sup> Islamic Fin. Servs. Bd., <http://www.ifsb.org>.

<sup>1132</sup> Islamic Fin. Servs. Bd., Standards Development, <http://www.ifsb.org/standard.php>.

The International Islamic Financial Market (“IIFM”) also located in Bahrain, was established out of collaboration of several central banks and government agencies.<sup>1133</sup> A key objective of the IIFM is to “encourage self-regulation for the development and promotion of the Islamic Capital and Money Market segment.”<sup>1134</sup> The IIFM issues trade guidelines, best practice procedures, and standardized financial contracts in its effort to promote Islamic financial systems.<sup>1135</sup>

Finally, the International Islamic Fiqh Academy, founded in Saudi Arabia, is an organ of the Organization of the Islamic Conference.<sup>1136</sup> Included in its objectives is to “study contemporary problems from the Sharia point of view and to try to find the solutions in conformity with the Sharia through an authentic interpretation of its content.”<sup>1137</sup> Rulings of the Fiqh Academy have been considered generally decisive on a number of recent Islamic finance issues.<sup>1138</sup>

Despite the emergence of the above regulatory bodies, no single one is regarded as a central point of reference for guidance on the issues of compliance with Islamic law, since these organizations sit on different theological ground to each other and having different impact. Receiving standards and guidance from various regulatory bodies creates a strain on presenting a cohesive message. Each has a different meaning as to what *Shari’a* compliance entails. This proves especially difficult in entering into a legal market such as the United States which requires strict requirements. There is already difficulty in entering into secular markets with conventional banks. For various Islamic banks to follow different regulatory bodies can add to this difficulty as the conventional market may not be able to understand or know how to accommodate Islamic financing. Additionally, because the guidelines are not binding law and each body has their own, it also adds in the difficulty of

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<sup>1133</sup> Int’l Islamic Fin. Mkt., <http://www.iifm.net> (noting that Bahrain, Brunei, Dubai, Indonesia, Malaysia, Pakistan, Sudan, and Saudi Arabia, among others were involved).

<sup>1134</sup> Int’l Islamic Fin. Mkt., Objectives, <http://www.iifm.net/AboutUs/CorporateProfile/Objectives/tabid/61/Default.aspx>.

<sup>1135</sup> Ibid.

<sup>1136</sup> Mohammad Taqi Usmani, *An Introduction to Islamic Finance* xiv (2002).

<sup>1137</sup> Organization of the Islamic Conference, Subsidiary Organs, [http://www.oic-oci.org/page\\_detail.asp?p\\_id=64#FIQH](http://www.oic-oci.org/page_detail.asp?p_id=64#FIQH).

<sup>1138</sup> Ibid.

advancing Islamic finance because the national laws in each country must determine how to reconcile the differences.

Furthermore, the risk of unexpected rule changes is one of the primary and most widely discussed obstacles to the development of Islamic finance in the mainstream and non-Muslim population. Many Islamic countries do not approve of the notion of binding precedent,<sup>1139</sup> meaning that clerics and scholars can change their opinions and disagree with past decisions. This practice leads to some degree of uncertainty as to whether a financial method or instrument currently considered *Shari'a*-compliant will remain so for the length of any given project or investment plan.<sup>1140</sup> The religious-based, non-binding legal nature of *Shari'a* compliant financing produces a risk of disagreement among religious leaders which is hard for many secular based legal systems to understand how to handle the Islamic financial system. The purpose of engaging in Islamic banking is to make profits while at the same time adhering to the principles and directives of the *Shari'a* law. For non-Muslims, who lack this second prong of religious conviction, conventional financing would be equally appealing in many ways. Those who engage in Islamic finance for religious purposes view their religious beliefs as intertwined with their conduct, both in their personal and professional undertakings.<sup>1141</sup>

However, the conservative side of Islamic banking can indicate further difficulties in Islamic finance developing and entering into new markets.<sup>1142</sup> An example of this hindrance is that conservative scholars argue for the end of *murabaha* contracts. The “phase-out” of *murabaha* investments of all types has been formally adopted by Al-Rajhi Bank (one of Saudi Arabia's major banks), al-Baraka (bank based in Bahrain), and the

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<sup>1139</sup> See Tamara Box & Mohammed Asaria, *Islamic Finance Market Turns to Securitization*, 21 INT'L FIN. L. REV., 20, 22 (2005) (discussing Saudi Arabia's “lack of a system of binding precedent”); John H. Vogel, *Securitization and Shariah Law*, in *Islamic Finance News 2009*, at 63, 64 (S. Sivaselvam et al. eds., 2009) (“[D]ecisions of courts are not often reported and, even if reported, are generally not considered to establish binding precedent for subsequent decisions.”).

<sup>1140</sup> See Agha, *supra* note 1108, at 189 (“[T]here is no requirement that just because a structure has been done in the past, that that structure will be considered viable a year from now”).

<sup>1141</sup> Robert R. Bianchi, *The Revolution in Islamic Finance*, 7 CHI. J. INT'L L. 569, 573 (2007) (examining the notion that Islamic bankers feel an obligation to be honest and moral because “their religion holds them to a higher standard”).

<sup>1142</sup> Vogel & Hayes, *supra* note at 9.

Government of Sudan.<sup>1143</sup> Such a phase-out is problematic for the Islamic finance industry because *murabaha* is a critical product that is offered.<sup>1144</sup> The concern regarding *murabaha* for conservative scholars is that it resembles conventional banking techniques. As noted, to be *Shari'a*-compliant, *murabaha* contracts require that the bank assumes ownership of the product before selling it to the client in order to receive the profit. However, there are many who doubt that the banks actually assume possession of the product. These “synthetic” *murabaha* transactions are “nothing more than short-term conventional loans with a predetermined interest rate incorporated in the price at which the borrower repurchases the inventory.”<sup>1145</sup>

The regulatory issues found in entering new markets, particularly secular ones can cause issues for the *murabaha* contracts. Nevertheless, although they are criticized, they are an essential service to Islamic banks.<sup>1146</sup> This debate demonstrates the vulnerability of Islamic banks and the fragmentation of regulatory bodies. Regardless of whether the conservative scholars succeed in their ways, it is crucial that the supervisory bank board knows what the consensus is from scholars. Many bankers and institutions are understandably confused by the different rulings of the *Shari'a* councils. Individual transactions or instruments are approved or disapproved and then later the ruling is reversed.<sup>1147</sup> This is problematic and risky in the eyes of regulators and legislators in areas such as the United States and the United Kingdom.

### **Combating Financial Crimes**

Islamic finance utilizes fairly sophisticated financial methods in order to create modern financial practices from simple contracts such as leases and sales.<sup>1148</sup> Although the

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<sup>1143</sup> Ibid.

<sup>1144</sup> Usmani, supra note 316, at 7 (explaining that clientele would be inconvenienced and encouraged to engage in conventional banking if *murabaha* is no longer available)

<sup>1145</sup> Vogel & Hayes, supra note 89, at 9.

<sup>1146</sup> Ibid.

<sup>1147</sup> Faud Al Omari and Mohammed Abdel Haq, *Islamic Banking: Theory, Practice, and Challenges* 110 (1996).

<sup>1148</sup> Mahoud A. El-Gama, supra note 330, at 1, (conveying that the methods used in Islamic banking were originally developed for regulatory arbitrage purposes).

industry seems to be largely self-regulating, since the events of 9/11, Islamic financial institutions undergo close scrutiny.<sup>1149</sup> As such, it would seem odd if terrorists or criminals who commit financial crimes would favour Islamic banks.<sup>1150</sup> Nevertheless, the regulatory arbitrage methods utilized in Islamic banking to hide interests and other factors considered forbidden under *Shari'a* law often resemble the methods used in criminal financial activity in recent years.<sup>1151</sup> The asset or commodity-based nature of Islamic finance, “which the industry advertises as its main virtue, may in fact be viewed as a source of weakness, since multiple-hop commodity and asset trading at losses or profits is a standard method used to hide the source (in money laundering) or destination and transmission route of funds (in terrorist financing).”<sup>1152</sup> Accordingly, it is important to examine the strengths and areas of improvement for Islamic financial institutions in handling financial crimes. Traditionally, the idea of moral hazard in relation to financial regulation has been in connection with policies that may encourage reckless or dishonest behaviour.<sup>1153</sup> An “Islamic moral hazard” can be identified in that particular aspects of Islamic banking may be susceptible to corrupt conduct. Within Islamic banking, because Islam prohibits acts that are connected with financial crimes, there is an assumption of righteous behaviour by employees and customers.<sup>1154</sup> Such assumptions can make an Islamic bank attractive to financial criminals so long as they may come across as good Muslims.<sup>1155</sup> However, a cohesive international regulatory scheme which includes specific regulations for Islamic banking would help minimize these assumptions.

The use of religion by Islamic institutions to avoid scrutiny or criticism can also be seen within the Islamic moral hazard. This is because until recently, the Islamic financial system was considered to be above the need for regulation due to the inherent morality of the system being required to comply with *Shari'a* law.<sup>1156</sup> Another factor is the potential

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<sup>1149</sup> Ibid.

<sup>1150</sup> Ibid.

<sup>1151</sup> Ibid.

<sup>1152</sup> Ibid.

<sup>1153</sup> Ron Terrell, *Islamic Banking: Financing Terrorism or Meeting Economic Demand?* 57 (2007).

<sup>1154</sup> Ibid.

<sup>1155</sup> Ibid. at 58 (discussing that the Dubai Islamic Bank suffered scandals involving its employees and improper loan practices).

<sup>1156</sup> Ibid.

for ambiguity when blending economics and *Shari'a*. Patience and even loan forgiveness for delinquent borrowers are encouraged in Islam's legal system. Late fees or penalties also often go unenforced. This is often seen as the opposite of economics in a secular system. The relationship between the banks and their depositors is also a part of the moral hazard. Although investment account holders are not guaranteed a fixed rate of return, they still expect a competitive one. Banks are then compelled to accommodate this expectation for fear of losing business.<sup>1157</sup> Banks manage this changing the profit distribution ratios in favor of investment account holders over shareholders. If there are no strict regulatory controls, activities such as that may continue.

*Shari'a* arbitrage can be viewed as an inherent weakness to the Islamic financial system.<sup>1158</sup> The adherence to pre-modern contract forms often results in loss of efficiency which is often justified as necessary for the "Islamization process."<sup>1159</sup> The development of an Islamic financial product begins with a conventional product for which an Islamic alternative does not exist. Bankers, *ulama*, and lawyers collaborate in order to reengineer the conventional product to make it *Shari'a* compliant, as well as attempting to make it compatible with the legal a regulatory systems by ensuring it is "as similar as possible to the convention product with which regulators are familiar."<sup>1160</sup> Islamic financial products are never completely detached from their conventional counterpart. The "degrees of separation" used to separate the Muslim customer from interest-bearing products often resembles the layering techniques of money launderers and criminal financiers.<sup>1161</sup> Furthermore, offshore financial centres are also utilized to minimize incorporation costs of special purpose vehicles, used in converting conventional products into *Shari'a* compliant ones, and also tax burdens.<sup>1162</sup> Thus, a lack of a single regulatory framework, along with the lack of sophistication of regulatory and law enforcement in the Middle East, where the majority of Islamic banks are found, may leave the Islamic financial system open for abuse

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<sup>1157</sup> Ibid

<sup>1158</sup> Mohammad A. El Gamal, *Islamic Finance: Law & Economics, and Practice* 194 (2006) (defining *Shari'a* arbitrage as a regulatory arbitrage whereby a financial product available in one market would be restructured under what is perceived as Islamic law in order to make it available in another market).

<sup>1159</sup> Ibid.

<sup>1160</sup> Ibid.

<sup>1161</sup> Ibid.

<sup>1162</sup> Ibid.

by criminals. This is particularly due to the lack of transparency in differentiating from the conventional products. Financial criminals are knowledgeable in layering techniques which are similar to *Shari'a* arbitrage that may allow the criminals to exploit Islamic banks since they are poorly regulated.<sup>1163</sup>

Islamic banks also can find problems with internal risk management. *Shari'a* boards do not always address this religiously sensitive matter, particularly as it relates to reducing the risk of financial instruments or deposit insurance.<sup>1164</sup> Some commentators argue, however, that Islamic banking is effective in combating financial crimes such as terrorist financing due to its overall regulatory scheme because it is more stringent since it must comply with *Shari'a* law.<sup>1165</sup> It is also argued that given the asset-backed nature that Islamic finance is more stable. Nevertheless, the Islamic financial system will not be able to achieve an international market due to the risks it produces and its lack of management. Even if those risks are merely perceived and not necessarily reality, regulators in the West will continue to remain cautious.<sup>1166</sup>

Yet, there is little proof that Islamic banking is connected with financial crimes any more than conventional banking.<sup>1167</sup> Islamic financial institutions also have many positive aspects that they utilize that may aid in the fight against financial crimes. Islamic banks are often required to adopt transparency, disclosure, and documentation to a greater extent than conventional banks.<sup>1168</sup> Islamic banks are not passive financiers concerned for interest payments and loan recovery and as such their disclosure standards should be more stringent. Additionally, considering the profit-loss share nature of Islamic transactions, Islamic banks must put effort into assuring that the client is involved in socially beneficial

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<sup>1163</sup> Ibid.

<sup>1360</sup> Ibid

<sup>1165</sup> Ahmad Mohamed Ali, *The Emerging Islamic Financial Architecture: The Way Ahead* 147, in, *Proceeding of the Fifth Harvard University Forum in Islamic Finance* (2003).

<sup>1166</sup> Matthew Moore, *US Feared British 'Sharia Banks' Would Finance Terrorist Groups*, THE TELEGRAPH (MAR. 15, 2011) available at <http://www.telegraph.co.uk/news/worldnews/northamerica/usa/8382544/US-feared-British-sharia-banks-would-finance-terrorist-groups.html> ([noting that the U.S. State Department was so concerned about sharia banks that it ordered U.S. diplomats in London to compile a report on the activities of them in Britain](#)).

<sup>1167</sup> Terrell, *supra* note 382, at 63. Terrell

<sup>1168</sup> Muhammad Ayub, *Understanding Islamic Finance*, (2007) (finding that lack of transparency in regard to murabaha transactions, where Islamic banks are required to provide all details of the cost, price, and payment method, may cause the transaction to be incompliant with *Shari'a*).

businesses that add value to the economy.<sup>1169</sup> Islamic banks must concern themselves with the character of the client and the nature of the business in order to avoid loss or risk their reputations.<sup>1170</sup>

There are those who counter these benefits by arguing that although the Islamic banks are not engaging directly in financial crimes such as terrorist financing, requirements like *zakat* are utilized to fuel the money to terrorist organizations.<sup>1171</sup> Again, there are cases of some Islamic banks involved in layering money which has its final recipient as terrorists, but that does not indicate a widespread issue.<sup>1172</sup> However, Zakat cannot be misused to finance terrorism because the act of terrorism is prohibited and goes against the basic principles of Islam.<sup>1173</sup> Furthermore, Islamic banks in Western countries must still comply with national laws regarding anti-money laundering and terrorist financing.<sup>1174</sup> When Islamic financial institutions appear not to abide by the laws on money laundering and terrorist financing because of lax enforcement of the laws by the authorities, financial institutions in other countries are prohibited from dealing with the non-abiding institutions and international pressure is exerted on the non-cooperative countries.<sup>1175</sup> As such, it is argued that existing and future laws and regulations can prevent Islamic financial institutions from engaging in illegal activities. In order to ensure that Islamic banks are doing all that is possible to combat financial crimes such as money laundering and terrorist financing, regulatory action again must be taken in a united front. No financial institutions

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<sup>1169</sup> Ibid.

<sup>1170</sup> Ibid.

<sup>1171</sup> Arabinda Acharya, Targeting Terrorist Financing: International Cooperation and new Regimes, 72-73 (2009) (noting that zakat transactions are generally off the books and hard to trace)

<sup>1172</sup> Ibid. (discussing the Bank of Credit and Commerce International which masked its financial transactions through multiple layers of accounts between a variety of financial systems with accounts in the names of charities, NGOs and businesses controlled by al Qaeda).

<sup>1173</sup> Arowosaiye, supra note 328, at 13. But see ACHARYA, supra note 1171, at 74 (noting that zakat transfers are generally off the books and therefore hard to trace).

<sup>1174</sup> U.S. Interest in Shariah Finance Opens Dangerous Doors, Critics say, FOX NEWS (Nov. 13, 2008) available at <http://www.foxnews.com/story/2008/11/13/us-interest-in-shariah-finance-opens-dangerous-doors-critics-say/> (commenting that Islamic financial institutions along with all other entities are subject to the Treasury Department's Executive Order 13224 where it is illegal for institutions to provide funds to charities that have been designated by the Department as supporters of terrorism).

<sup>1175</sup> J. Winer, Hearing on the Administration's National Money Laundering Strategy for 2001, available at [http://www.fas.org/irp/congress/2001\\_hr/092601\\_winer.html](http://www.fas.org/irp/congress/2001_hr/092601_winer.html).



should open or maintain anonymous accounts or any account with a fictitious name.<sup>1176</sup> Islamic banks must be aware of businesses that may seem legitimate but are in fact not. Each bank should provide a written policy approved by its board of directors, incorporating the minimum information and data to be obtained before approving the opening of an account for client. Such data should be in depth and include the client's identity, profession or business and sources of their income, the purpose for opening the account and other information that can provide additional certainty. An identification process should also be utilized even for a casual customer who may be there for foreign exchange, foreign transfer, lease of safe deposit locker or any other service.

The banks should also ensure the relation involved of the customer in both new and existing accounts. If a client would want to open an individual account, the bank should obtain a statement from the client that they are in fact the beneficiary of the account being opened in their name. In the case that someone is opening an account on behalf of another; the bank should obtain documents evidencing the nature and scope of the legal representation.<sup>1177</sup> If an institution or legal person opens an account, a verification process that the institution or company does in fact exist should occur and the bank should also obtain the names of those authorized as directors and verify their identities. The banks should also regularly update the basic information they obtain from clients and their activities. This will enable the banks to identify any changes that may cause suspicion or any discrepancies in the data, verifying the soundness of the data the bank is in possession of will also enable them to monitor for criminal behaviour.

Money laundering and terrorist financing, along with other financial crimes, may use advanced techniques in order to conceal the identity of a concerned person or entity. Great attention must be paid to identifying the risks involved and the appropriate actions carried out in order to prevent such methods. Organized criminals and terrorists often

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<sup>1176</sup> Jae-Myong Koh, *Suppressing Terrorist Financing and Money Laundering* - 22 (2006) (“Government sources and other experts on terrorism indicated that a large portfolio of ostensibly legitimate businesses continues to be maintained on behalf of Usama bin Laden by a number of as of yet unidentified intermediaries and associates across North Africa, Europe, the Middle East and Asia”).

<sup>1177</sup> *See* *Ibid.* at 15 (noting that terrorist organization without specific constituency support and strengthen each other through financial support).

utilize others in an attempt spread influence and to establish a parasitic operational base in targeted areas.<sup>1178</sup> This allows them to create friendships with those outside of the organization which often can do some of their bidding. Any complex or unusually large transactions deserve the utmost attention as well. This is critical considering that money launderers often utilize layering techniques in order to disguise their source of illicit funds. However, it is also critical for terrorist who use the technique to hide where the destination of the money is.<sup>1179</sup> Accordingly, unusual patterns of transactions which may not have an apparent economic or lawful purpose or objective should be closely examined. The same if the transactions appear to be inconsistent with the client's nature of business, or raises doubts on the true nature of the transactions.

### **Islamic finance and ethical or social responsible investment**

There is a significant reason for the rise of Islamic Banking is its overlaps with ethical or social responsible investment. The strong ethical principles and religious underpinnings of Islamic finance have renewed discussion that Islamic finance has an integral role in the stabilization of a healthy financial system. The Sharia persistently underlines the importance of stewardship for people looking after other people's wealth. As its foundation rests on partnership and cooperation, Islamic finance relies on equity participation and risk sharing, the system of Islamic finance in principle advocates for an equal distribution of risk and cooperation between fund-providers (investors) and fund-users (entrepreneurs). In promoting the understanding of Islamic finance, the European Central Bank has noticeably illuminated the overlaps between ethical and social investment, which incorporates social and environmental considerations into the process of selecting investment options and gives preferences to companies above a certain threshold of corporate social responsibility. This decisively concludes that "Islamic finance, therefore, falls under ethical finance"<sup>1180</sup> a multitude of criteria for qualifying for ethical or socially responsible investment align with principles of Islamic finance,

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<sup>1178</sup> Ibid.

<sup>1179</sup> See *Ibid.* at 27 ("Money laundering begins with brushing off the audit trail and ends by achieving legitimization, while terrorist financing begins with money making and ends by distributing it").

<sup>1180</sup> Di Mauro, F, Caristi P, Couderc, S, Di Maria, A, Ho, L, Grewal, BK, Masciantonio, S, Ongena, S & Zaher, S. 2013, "Islamic Finance in Europe" Occasional Working Paper Series, no. 146, European Central Bank. Available from: <https://www.ecb.europa.eu/>. [2 April 2016].

including corporate citizenship, environmental management, product safety, and the exclusion of the haram industries of alcohol, tobacco, gambling, defence contracting and nuclear power.<sup>1181</sup>

Until recently, many of the issues of governance manifest in the more developed, markets of the West have not been of significant concern in Islamic Banking.<sup>1182</sup> However, as Islamic finance gains greater prominence and market share, corporate governance in IIFS has begun process of internationalization and standardization. Sharia corporate governance has expanded from the requirement of Sharia supervisory boards to include a myriad other component such as Sharia auditing, Sharia review, Sharia research, and Sharia risk management.<sup>1183</sup> However, fitting international best principles to Islamic Banking raises questions about the necessity of harmonization. Professor Rider has argued that because of the high moral content of the tenets of Sharia, and its adherence to integrity and fair dealing, the restricted context in which Sharia, and its adherence to integrity and fair dealing, the restricted context in which Sharia-compliant institutions must operate arguably does not require the procedural principles of Western governance and might even produce better governance standards. However, in Islamic finance exists tension between financial innovation, as allowed by more liberal interpretations of the Sharia, and a strict reading of the law.<sup>1184</sup> Conventional banks can charge penalties to a borrower defaulting on his/her loan. However, in Islamic finance, banks may do so only if they transfer the same amount to charity. For religious purposes, Islamic lenders may hesitate from imposing penalty charges that could help maintain the borrower in relative solvency.

For the above reasons, though Islamic banks and conventional banks displayed no differences in financial stability, fully fledged IIFS in general displayed a lower degree of stability compared to conventional banks during the period 2008-9.<sup>1185</sup> In terms of the

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<sup>1181</sup> Ibid

<sup>1182</sup> Barry A.K Rider (2012) “Corporate Governance for Institutions Offering Islamic Financial Services” Ch.5 from *Islamic Finance: Law and Practice*. Ed. CN Nethercrott and MD Eisdenberg from Oxford University Press, Oxford.

<sup>1183</sup> Muneeza, A 2014, ‘Sharia’h Governance Applicable to Islamic Banks in Malaysia: Effect of Islamic Financial Services Act 2013’ in *Developing Role of Islamic Banking and Finance: From Local to Global Perspective*, ed. FH Beseiso, Emerald Group Publishing Limited, Bigley, UK, pp. 31-44.

<sup>1184</sup> Ibid

<sup>1185</sup> Gamaginta & Rokhim, R 2011, *The Stability Comparison between Islamic Banks and Conventional Banks: Evidence in Indonesia*, presented at the 8<sup>th</sup> International Conference on Islamic Economics and

performance of capital markets, the weekly returns on Islamic Equities portfolio (Sharia) outpace the portfolios of the overall European market and market without financial forms. However, when the economy experiences an upward growth trend, Sharia-compliant equities slightly underperform the market portfolio. The empirical evidence gathered thus far demonstrates that the financial crisis tested the resilience of Islamic finance, which lacks the risk frameworks of conventional banking for faster recovery. Furthermore, among the main causes of 2008 financial crisis were excessive debt, risky investment, and extensive use of over-the counter (OTC) derivatives for speculation, primarily on the part of the major financial institutions but also by households.<sup>1186</sup>

Each of these elements is part of a self-reinforcing cycle, with speculation driving up assets.<sup>1187</sup> Because of Islamic banking is based on the principle of risk-sharing, as opposed to risk-transfer, and because it is linked to the real economy, it has inherent limits to the amount of debt-creation which can take place. Unlike traditional bond markets, which are primarily debt-based, ‘Sukuk’ (bond backed by real assets) are frequently equity-based and contain risk of sharing features which can enhance the stability of financial markets. Further, Islamic finance’s prohibition on derivatives, options, and futures trading, which nearly eclipsed an obviously unsustainable \$600 value (11 times global GDP) in 2007,<sup>1188</sup> helps reduce systemic risks in economy. One study cited in the World Bank’s Report that “during the years immediately after the crisis, Islamic banks were more resilient and achieved higher credit and asset growth than conventional banks.” This was in part because Islamic Banks had higher capitalization and liquidity reserves to cover losses,<sup>1189</sup> as opposed to leverage ratios as high as 40 to 1 at the major investment banks.<sup>1190</sup>

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finance, Doha, Qatar, 19-21 December.

<sup>1186</sup> Financial Crisis Inquiry Commission, *The financial Crisis Inquiry Report*, Washington, DC. U.S. Government, 2011, p. xviii-xxviii.

<sup>1187</sup> Peter Nolan, *Capitalism and Freedom*, London: Anthem Press, 2008, p. 132-138.

<sup>1188</sup> Hossein Askari, et al., *The Stability of Islamic Finance*, Singapore: John Wiley & Son, 2010, p. 141.

<sup>1189</sup> Habib Ahmed, et al., “On the Sustainable Development Goals and Role of Islamic Finance, pp.14-17

<sup>1190</sup> Financial Crises Inquires Commission, *The Financial Cries Inquiry Report*, p. xix

### **Is Islamic Finance promoting more stability than traditional banking services?**

In the context of global financial crises- 2007-9, relatively nascent Islamic banks may still trail behind the recovery rate and stability of conventional banking institutions. Several empirical studies have assessed the effect of the financial crisis of 2007-9 on the performance of Islamic Banks and 49, conventional banks in fifteen countries, in 2007, before the onslaught of the crisis the group of Islamic banks outperformed the group of traditional banks; in 2008, the performance had no significant differences; in 2009, conventional banks outperformed Islamic banks. The 2008 results reflect that the crisis impacted both Islamic banks and conventional banks, while the faster recovery of conventional banks in the following year could be explained by the effect of the crisis on the real economy in which Islamic Banks typically operate.<sup>1191</sup> The slower post crisis recovery of Islamic Banks can also indicate the weaker risk management of these institutions as well as their infancy as obstacles for fast recovery.

Another study across 120 Islamic banks and conventional banks across eight countries during the period 2007-9, shows that the profits of Islamic banks decreased by more than those of conventional banks in 2009.<sup>1192</sup> Additionally, Islamic financial institutions has demonstrable success with high-value, durable public projects, they have yet to prove they can organize major composite investments outside of infrastructure, let alone address the liquidity shortage and raise enough capital to be independently viable. As it stands, Islamic financial institutions are not so different from conventional banks.

The infrastructure and tools for liquidity risk management, still weak and emerging at most Islamic banks financial institutions, can account for this decline in profitability shortly after the crisis. During a financial panic, when depositors might try to liquidate their savings enmasse, the profit-and loss-sharing model can make Islamic banks more vulnerable to large quantities of deposit withdrawals.<sup>1193</sup> Conventional Banks can charge penalties to a borrower defaulting on his/her loan. However, in Islamic finance, banks may do so only if they transfer that same amount to charity. For the above reasons, though Islamic banks and conventional banks displayed no differences in financial stability, fully-fledged IFIS in general displayed a lower degree of stability compared to conventional banks during the period 2008-2009.<sup>1194</sup>

## Conclusion

In my opinion, Islamic finance is less a substitute for conventional finance and more a supplement to it, offering ethical and religious products and services for those who want them, and perhaps to a small extent increasing access to finance by micro-enterprises. However, the heart of Islamic finance –equity- is missing from IFIs; they are functionally closer to traditional banks than they are apart. Most IFIs are choosing to avoid risky and low margin businesses, instead opting to transfer risk and guarantee returns from large borrowers through non-PLS instruments.

In addition, on top of the boards ‘transparency and accountability issues, there is still significant disagreement across the Muslim world as to which scholars are qualified to sit on such boards and whose conceptions of ‘Sharia- compliant’ are acceptable or not. Furthermore, while the IFIs do appear to be slightly more resilient than conventional institutions, the delayed collapse of Dubai’s real estate market further exemplifies the fact that IFIs and the societies in which they operate are inextricably linked to the majority non-Islamic financial sector. The ties between the two will only strengthen as more non-Muslim countries issue sukuk and more conventional institutions open subsidiary IFIs.<sup>1195</sup>

This chapter has demonstrated what is Islamic banking? The chapter also discussed the legal and regulatory issues that have prevented Islamic banking from flourishing as an international contender in the financial industry. Furthermore, discussion was given to the issue of financial crimes, with particular attention to money laundering and financing terrorism. Although there have been some cases of certain Islamic banks being involved in one manner or another in these financial crimes, there is little proof that the Islamic financial system is connected to money laundering and terrorist financing any more than

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<sup>1195</sup> Mehmet Sarac and Feyyaz Zeren, “The Dependency of Islamic Bank rates on conventional bank interest rates: further evidence from Turkey,” *Applied Economics*, Vol. 47, No. 7 (2015), pp. 669-679.

conventional banks. Similar to all other banks, Islamic banks are also required to be wary and report suspicious transactions.

They must follow national laws where they operate and follow international regulations that cover such crimes. A hindrance of Islamic banking, however, is the lack of cohesive regulatory system directed at Islamic financial institutions. This chapter listed several regulatory suggestions that should be unified in order to help promote safe banking habits.

Islamic finance today appears to be competing aggressively with conventional finance. If Islamic banking is to develop as a serious banking alternative though, the industry must be prepared for innovation. The strategy thus far seems to suggest an intention to streamline Islamic finance products with the conventional financial markets, and to offer a viable alternative. Nevertheless, this strategy has exposed the Islamic finance industry to the risk of being labelled as an industry that is encouraging tactics that circumvent Islamic law injunctions and can make it appear to be more favourable with financial crimes.

Islamic finance offers a great incentive for Muslim countries to develop financial markets and develop them to a level where they are attractive to international participants. Islamic banking also provides a great alternative for non-Muslims, but the industry must proceed in a manner that demonstrates a cohesive regulatory approach and one that can enter foreign markets and encourage sound business practice.

Another issue of financial misconduct concerning financial stability and the role of International Financial Institutions is the corruption and the stolen asset recovery which will be examined in the next chapter.

## CHAPTER 7

### CORRUPTION AND STOLEN ASSET RECOVERY

#### Introduction

Over the last few decades, increasing attention has been paid not only to prosecuting those who commit crimes but also to depriving them of the proceeds of these crimes.<sup>1196</sup> Corruption and the recovery of stolen assets have become prominent issues in international law.<sup>1197</sup> Corruption can be found in countries throughout the world, although the most affected by its impact are developing countries and transition countries.<sup>1198</sup> The seizure and recovery of the proceeds of recovery is known as asset recovery.<sup>1199</sup> Stolen asset recovery is quickly emerging as a key aspect in the fight against corruption and the promotion of the rule of law.<sup>1200</sup> Asset recovery is an effective tool as it helps to deter corruption by demonstrating to corrupt officials that they will be deprived of their illicit gains along with improving international cooperation to achieve the end goals.<sup>1201</sup> However, stolen asset recovery also presents its difficulties in that there are a variety of legal and practical issues, including insufficient legal precedent, lack of cooperation from offshore financial institutions and domestic political intervention.<sup>1202</sup>

This chapter will examine corruption and the use of asset recovery as a means to combat it. First, a discussion will be had on what corruption is and how it has been defined.

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<sup>1196</sup> Richard Alexander, *The pursuit of criminal property*, p. 447. *Research Handbook on International Financial Crime* Edited by Barry Rider (Edward Elger Publishing 2015).

<sup>1197</sup> Jean- Pierre Brun et al, *Public Wrongs, Private actions: Civil Lawsuits to Recover Stolen Assets 1* (Stolen Asset Recovery Initiative, The World Bank, 2014).

<sup>1198</sup> Larissa Gray et, al., *Few and Far: The Hard Facts on Stolen Asset Recovery 1*, (Stolen Asset Recovery Initiative, The World Bank, 2014) (discussing that corruption slows economic growth and development, affects the quality and accessibility of public services and infrastructure, erodes public confidence in government, reduces private sector development and weakens the rule of law).

<sup>1199</sup> *Ibid.*

<sup>1200</sup> Mark V. Vlastic & Gregory Cooper, *Beyond the Duvalier Legacy: What New "Arab Spring" Governments Can Learn from Haiti and the Benefits of Stolen Asset Recovery*, 10 *NW. U. J. INT'L HUM. RTS.* 19, 1 (2011) (noting that the importance of stolen asset recovery has increased since the post-Arab Spring).

<sup>1201</sup> Gray et Al., *supra* note 1198, at 1.

<sup>1202</sup> Vlastic & Cooper, *supra* note 1200, at 1.



Next, the chapter will analyse asset recovery and international developments that have occurred in this discipline, focusing on the United Nations and particularly the World Bank. The chapter will also provide an overview of what the United States and the United Kingdom have done in their pursuit to aid in asset recovery. Lastly, this chapter advocates for the use of civil suits as a means to facilitate combating stolen assets and will conclude on this note.

### **What is Corruption?**

Corruption can be viewed as the abuse of power for personal gain. When perpetrated by public officials, these abuses are considered public wrongs.<sup>1203</sup> Many would argue that corruption is a universal phenomenon.<sup>1204</sup> To this end, corruption has been found to cause a variety of negative impacts in the world.<sup>1205</sup> Although it seems virtually impossible to rid the world of corruption, the international community has formally condemned it and continues to make efforts in order to suppress and deter it.<sup>1206</sup>

Corruption is not an easy word to define due to the fact its meaning will derive principally from cultural norms.<sup>1207</sup> The meaning of “corruption” can therefore shift depending on the speaker.<sup>1208</sup> More than ten years ago, corruption was seen as being tied to doing business internationally and, for better or worse, an inescapable reality.<sup>1209</sup> Today,

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<sup>1203</sup> William Blackstone, *Commentaries of the Laws of England*, bk. 4, ch. 1, *Of the Nature of Crimes; and Their Punishment* 1765–69. (“breaches and violations of duties due to the whole community, considered as a community, in its social aggregate capacity”)

<sup>1204</sup> *Corruption in International Business: The Challenge of Culture and Legal Diversity*, 179-80 (Sharon Eicher ed., 2008).

<sup>1205</sup> Claes Sandgren, *Combating Corruption: The Misunderstood Role of Law*, 39 *INT’L LAW.* 717, 730, (2005) (finding that corruption causes poverty.); Daniel Kaufmann et al., *Governance Matters* (The World Bank Development Research Group Macroeconomics and Growth & World Bank Institute Governance, Regulation and Finance, Working Paper No. 2196, 1999), <http://siteresources.worldbank.org/intwbigovantcor/resources/govmatrs.pdf> (establishing that corruption reduces private investment), Elizabeth Spahn, *International Bribery: The Moral Imperialism Critiques*, 18 *MINN. J. INT’L L.* 155, 224-25 (2009) (discussing how corruption frustrates efforts to achieve human rights).

<sup>1206</sup> Winfield Bean, *Hyperbole, Hypocrisy, and Hubris in the Aid-Corruption Dialogue*, 41 *GEO. J. INT’L L.* 781, 786 (2010)

<sup>1207</sup> Cf. *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Supreme Court Justice Potter Stewart once declared that although he could not define pornography, he knew it when he saw it)

<sup>1208</sup> See Susan Rose – Ackerman, *Governance and Corruption, in the global crisis*, Solution 301 (Bjorn Lomborg, ed., 2004).

<sup>1209</sup> Demetrios Argyriades, *The International Anticorruption Campaigns: Whose Ethics? In Where Corruption Lives* 217 (Gerald E. Caiden, O.P. Dwivedi & Joseph Jabbra eds., 2001).

as noted, corruption is considered as one of the fundamental obstacles to development, which must be prevented and defeated.<sup>1210</sup> The word “corruption” has been derived from the Latin word *corrupts*, meaning to break.<sup>1211</sup> The word’s Latin roots emphasize the destructive effects of corruption on society.<sup>1212</sup> In its everyday meaning, *corruption* is said to encompass the situations where agents and public officials break society’s trust in them.<sup>1213</sup> The Oxford English Dictionary defines “corruption” as the “perversion or destruction of integrity in the discharge of public duties by bribery or favours; the use or existence of corrupt practices, *esp.* in a state, public corporation etc.”<sup>1214</sup>

Over the years, governments have focused their anti-corruption efforts on fighting administrative corruption.<sup>1215</sup> Administrative corruption often involves the payment of small-scale bribes to mid and low level government officials.<sup>1216</sup> Today, the focus has shifted to grand corruption. Grand corruption, also known as political corruption, embodies large bribes given in connection with major interactions, such as large infrastructure projects or arms sales, and the abuse of political power to extract and accumulate for private gain.<sup>1217</sup> The key difference between these types of corruption is that “administrative corruption reflects specific weaknesses within different systems, while grand corruption involves the distortion and exploitation of entire systems for the benefit of private interests.”<sup>1218</sup> Grand corruption is often associated with the massive redirection of public funds for the private use of the political elite.<sup>1219</sup> The most notorious culprits have stolen billions of dollars from their countries for their own personal wealth accumulation.

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<sup>1210</sup> See USAID Anticorruption Strategy, available at [http://www.usaid.gov/our\\_work/democracy\\_and\\_governance/publications/pdfs/ac\\_strategy\\_final.pdf](http://www.usaid.gov/our_work/democracy_and_governance/publications/pdfs/ac_strategy_final.pdf).

<sup>1211</sup> Colin Nicholls et al., *Corruption and misuse of Public Office 1* (2d Ed., 2011)

<sup>1212</sup> *Ibid.*

<sup>1213</sup> *Ibid.*

<sup>1214</sup> *See* *ibid.* (Citing Oxford English Dictionary 1989 Edition).

<sup>1215</sup> Mary Evans Webster, *Fifteen Minutes of Shame: The Growing Notoriety of Grand Corruption*, 31 *HASTINGS INT'L & COMP. L. REV.* 807, 808 (2008).

<sup>1216</sup> Claes Sandgren, *Combating Corruption: The Misunderstood Role of Law*, 39 *INT'L LAW.* 717, 723 (2005) (noting mid and low level government officials included police officers, customs personnel, medical doctors, and teachers).

<sup>1217</sup> U4 Anti-Corruption Resource Center, *what is Political Corruption?* available at <http://www.u4.no/themes/political-corruption/introduction.cfm#definitions>.

<sup>1218</sup> Steven E. Hendrix, *New Approaches to Addressing Corruption in the Context of U.S. Foreign Assistance with Examples from Latin America and the Caribbean*, 12 *SW. J. L. & TRADE AM.* 1, 4 (2005).

<sup>1219</sup> *Ibid.*

Transparency International (“TI”) is an international NGO that has been at the frontline of anticorruption efforts since the end of the Cold War when the incentives to overlook corruption in receiving nations subsided.<sup>1220</sup> TI developed a Corruption Perceptions Index which measures the perceived levels of public sector corruption around the world.<sup>1221</sup> In its report, TI has found no country received a perfect score and that more than two-thirds of countries score below 50, on a scale from 0 (highly corrupt) to 100 (very clean).<sup>1222</sup> Currently, the only universal legally binding instrument is the United Nations Convention against Corruption (“UNCAC”).<sup>1223</sup> In December 2000, the General Assembly recognized the need for an effective international legal instrument to combat corruption that would be independent from the Convention against Transnational Organized Crime.<sup>1224</sup> UNCAC represents the results of serious efforts put forth by the international community in order to address the specific aspects of corruption.<sup>1225</sup>

UNCAC distinguishes itself from other international conventions in that it recognizes that the problem of corruption extends beyond bribery and that other aspects of corruption must be addressed in order to make global efforts successful.<sup>1226</sup> The signatories declare themselves to be “[c]onvinced that the illicit acquisition of personal wealth can be particularly damaging to democratic institutions, national economies and the rule of law, [and] [d]etermined to prevent, detect and deter in a more effective manner international transfers of illicitly acquired assets and to strengthen international cooperation in asset recovery.”<sup>1227</sup> One of the most contentious and important aspects of the UNCAC is its

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<sup>1220</sup> Winfield Bean, *supra* note 1206, at 789.

<sup>1221</sup> Transparency International, *Corruption Perceptions Index 2014: Results*, available at [http://www.transparency.org/cpi2014/results\(2014\)](http://www.transparency.org/cpi2014/results(2014)).

<sup>1222</sup> *See Ibid.* (finding that a poor score is likely due to widespread bribery, lack of punishment for corruption and public institutions that do not respond to citizens’ needs).

<sup>1223</sup> United Nations Convention against Corruption, opened for signature 31 October 2003, 2349 UNTS 41 (entered into force 14 December 2005) available at <http://www.unodc.org/unodc/en/corruption> [hereinafter UNCAC]

<sup>1224</sup> United Nations Convention against Corruption, Background, <http://www.unodc.org/unodc/en/treaties/CAC/index.html>.

<sup>1225</sup> *See Ibid.* (commenting that to date there are 140 signatories to the Convention).

<sup>1226</sup> Philippa Webb, *The United Nations Convention Against Corruption: Global Achievement or Missed Opportunity?* 8 J. INT’L ECON. L. 191, 191 (2005).

<sup>1227</sup> Preamble, UNCAC, available at [http://www.unodc.org/pdf/crime/convention\\_corruption/signing/Convention-e.pdf](http://www.unodc.org/pdf/crime/convention_corruption/signing/Convention-e.pdf)

provisions regarding asset recovery. Asset recovery is a major issue for countries where grand corruption has resulted in the loss of millions of dollars that could be used for poverty mitigation and development of civil services.<sup>1228</sup> Leaders involved in the negotiations for the UNCAC recognized that asset recovery was fundamental to the Convention and a significant indicator of the political will of states to truly work together to fight grand corruption.<sup>1229</sup> The Convention ultimately dedicated an entire chapter to asset recovery.<sup>1230</sup>

### **Asset Recovery and its Role in Combating Corruption**

Asset recovery has developed into a critical tool in combating transnational corruption.<sup>1231</sup> However, the utilization of asset recovery is filled with both legal and practical difficulties.<sup>1232</sup> Although there are exuberant amounts of money involved, recovering stolen assets does not always simply focus on money. This tool has been used to aid in deterrence efforts as well as help in fighting the impunity that is often associated with financial crimes.<sup>1233</sup> In many cases, asset recovery will fill three distinct purposes: recovering monies to fund governments programs and initiatives that help their people; providing a semblance of justice for victims while often challenging a political culture of impunity; and deterring officials from engaging in future corruption.<sup>1234</sup> Although these objectives are difficult, they are seen as worthwhile in accomplishing.

In addition to being addressed in anticorruption instruments, asset recovery has also been recognized in international financial regulations. Although these regulations do not focus exclusively on anticorruption, they often must interact with the anticorruption

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<sup>1228</sup> Webster, *supra* note 1215, at 811.

<sup>1229</sup> Webb, *supra* note 1226, at 208.

<sup>1230</sup> *See* UNCAC, *supra* note 1223, at ch. V.

<sup>1231</sup> Thomas R. Snider & Won Kidane, *Combating Corruption Through International Law in Africa: A Comparative Analysis*, 40 *CORNELL INT'L L.J.* 691, 741 (2007).

<sup>1232</sup> Vlasic & Cooper, *supra* note 1200, at 3 (listing such difficulties as insufficient legal precedent, lack of cooperation from offshore financial centers, and domestic interference encountered in asset recovery).

<sup>1233</sup> *Ibid.*

<sup>1234</sup> *Ibid.*

instruments.<sup>1235</sup> Illustrations of this include the Financial Action Task Force recommendations,<sup>1236</sup> the guidance of the Basel Committee on Banking Supervision<sup>1237</sup> and the Wolfsberg Anti-Money Laundering Principles for Private Banking, revised in June 2012.<sup>1238</sup> As such, States' obligations laid out under these international financial instruments must be read in conjunction with their obligations under international anti-corruption instruments.

The success of asset recovery can also depend on the regulation of the financial sector.<sup>1239</sup> Financial regulations often complement and strengthen the anti-corruption instruments, although they have also been seen to contradict each other on certain issues.<sup>1240</sup> Corporate law also influences the success of asset recovery provisions. An example of this is the Stolen Asset Recovery (StAR) Initiative (to be discussed below)

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<sup>1235</sup> One example is international accounting standards. Following the example of the FCPA, certain multilateral conventions contain separate provisions on accounting standards (for example, OECD Convention art 8). Imposing stringent accounting requirements to a certain extent brings the anti-corruption effort under the rigorous oversight of market and stock exchange watchdogs such as the SEC in the US.

<sup>1236</sup> Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation: The FATF Recommendations (February 2012) [hereinafter FATF Recommendations]. The FATF is an independent intergovernmental body that develops and promotes policies to protect the global financial system against money laundering and terrorist financing: see generally Financial Action Task Force, About Us: Who We Are <http://www.fatf-gafi.org/pages/aboutus/>. See also Financial Action Task Force, Laundering the Proceeds of Corruption, (Report, July 2011).

<sup>1237</sup> For documents issued by the Basel Committee on Banking Supervision ("BCBS"): see generally Bank for International Settlements, Basel Committee-- Last 3 Years available at <http://www.bis.org/list/bcbs/index.htm> The BCBS has released guidance on a number of topics: see, e.g., Basel Committee on Banking Supervision, Prevention of Criminal Use of the Banking System for the Purpose of Money-Laundering (Statement, December 1988) available at <http://www.bis.org/publ/bcbsc137.pdf>; Basel Committee on Banking Supervision, Consolidated KYC Risk Management (Guidance Document, Bank for International Settlements, October 2004) available at <http://www.bis.org/publ/bcbs110.pdf>; Basel Committee on Banking Supervision, Due Diligence and Transparency regarding Cover Payment Messages Related to Cross-Border Wire Transfers (Guidance Document, Bank for International Settlements, May 2009) available at <http://www.bis.org/publ/bcbs154.pdf>.

<sup>1238</sup> Wolfsberg Group, Wolfsberg Anti-Money Laundering Principles for Private Banking (May 2012) available at, <http://www.wolfsberg-principles.com/pdf/Wolfsberg-Private-Banking-Principles-May-2012.pdf>. The Wolfsberg Group is an industry-led initiative comprised of 11 global banks. The Group aims to elaborate standards on known-your-customer, money laundering and counterterrorism financing issues: see generally Wolfsberg Group, Global Banks: Global Standards (2012) available at <http://www.wolfsberg-principles.com>.

<sup>1239</sup> Jan Wouters et. al., The International Legal Framework Against Corruption: Achievements and Challenges, 14 MELB. J. INT'L L. 205, 261 (2013).

<sup>1240</sup> Cf. Indira Carr & Miriam Goldby, Recovering the Proceeds of Corruption: UNCAC and Anti-Money Laundering Standards, 2 J. of Bus. L. 170, 180. (2011) (indicating that the FATF recommendations may conflict with the UNCAC provision as to the requirement of double criminality);

report highlighting the use of complex corporate vehicles to launder the proceeds of corruption.<sup>1241</sup> The report details how the corporate veil shields the corrupt from investigations.<sup>1242</sup> On the same note, private actors can play a critical role in the successful enforcement of asset recovery provisions. Know-your-customer (“KYC”) rules, for instance, require banks to increase due diligence efforts<sup>1243</sup> for bank accounts of high-level politicians or in the case of large financial transactions.<sup>1244</sup> However, a limitation of these rules is that they are more apt to identify grand corruption and as such, are limited in their ability to detect petty corruption that can accumulate over time.<sup>1245</sup> Although other forms of corruption can also escape detection from private actors, it highlights the necessity of a comprehensive anti-corruption approach. Accordingly, the international developments in asset recovery attempt to create a wide breath of mechanisms.<sup>1246</sup>

### **International Developments in Asset Recovery**

Legal provisions that utilize asset recovery try to ensure that property that was taken from its rightful owner through corrupt practices is returned.<sup>1247</sup> The goals of asset recovery are to tackle the economic motivations for corrupt acts. This is accomplished because in addition to the persons involved in corruption being held criminally or civilly liable (with a focus on the individual), but also the proceeds from their corrupt acts can also be seized (with a focus on the assets).<sup>1248</sup> To this aim, international laws and enforcement efforts focused on this matter have begun to accelerate as are discussed below.

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<sup>1241</sup> Emile van der Does de Willebois et al, *The Puppet Masters: How the Corrupt Use Legal Structures to Hide Stolen Assets and What to Do About It* (Report, Stolen Asset Recovery Initiative/World Bank, 24 October 2011).

<sup>1242</sup> *Ibid.*

<sup>1243</sup> FATF Recommendations, *supra* note 1236, at 14 (requiring banks and other private actors to identify potentially corrupt actors); see also United Nations Guiding Principles, UN Doc A/HRC/17/31, annex.

<sup>1244</sup> See, e.g., Basel Committee on Banking Supervision, *Customer Due Diligence for Banks* (Guidance Document, Bank for International Settlements, October 2001), <http://www.bis.org/publ/bcbs85.pdf>.

<sup>1245</sup> Carr & Goldby, *supra* note 1240

<sup>1246</sup> See Tim Daniel & James Maton, *Recovering the Proceeds of Corruption by Public Officials: A Case Study in Recovering Stolen Assets* 463 (Mark Pieth ed., 2009) (reiterating that asset recovery efforts need flexibility and that a range of mechanisms are needed in order to achieve the desired results).

<sup>1247</sup> Wouters et al., *supra* note 1247, at 265 (commenting how regulations requiring rules on know your customer (‘KYC’), mandatory registration of suspect transactions, record-keeping and bank secrecy help to aid in asset recovery).

<sup>1248</sup> *Ibid.*

## United Nations Convention against Corruption

As noted above, UNCAC is the first truly global anti-corruption treaty, focusing on a “common language” for the anti-corruption movement.<sup>1249</sup> UNCAC was adopted by the General Assembly on October 31, 2003 and opened for signatures on December 9, 2003. The treaty entered into force two years ago. The number of signatures and ratifications is testimony to the broad international consensus on the UNCAC.

UNCAC is predominantly phrased in non-mandatory terms where it concerns preventive measures, leaving it to state parties to decide concrete implementation measures.<sup>1250</sup> Nonetheless, UNCAC requires states parties to adopt measures (without imposing a detailed one-size-fits-all implementation) in a wide range of areas: they must set up anti-corruption bodies; establish appropriate procurement systems; strengthen the integrity of the judiciary; take measures to prevent private sector corruption; promote the active participation of civil society; and institute a comprehensive regulatory regime for banks and other financial institutions to prevent money laundering.<sup>1251</sup> These specific provisions are preceded by the chapeau paragraph of article 5, which requires that states parties adopt comprehensive and coordinated anti-corruption policies that promote the participation of society and reflect the principles of the rule of law, proper management of public affairs and public property, integrity, transparency and accountability.<sup>1252</sup> Thus, the requirement of good governance is the basic thrust of this general provision. During the negotiations of UNCAC, developing countries prioritized the inclusion of asset recovery provisions<sup>1253</sup> and their efforts were reinforced with the support of the United States on this

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<sup>1249</sup> Antonio Argandoña, *The United Nations Convention against Corruption and Its Impact on International Companies*, 74 *J. of Bus. Ethics* 481, 485 (2007).

<sup>1250</sup> UNCAC, *supra* note 1223, at Ch. II.

<sup>1251</sup> *See id.* arts. 6-14. Although the basic focus of these provisions is that states parties “shall” adopt such measures, this requirement is often weakened by adding qualifiers such as “in accordance with the fundamental principles of its domestic law.” *see, e.g., id.* art. 13.1.

<sup>1252</sup> *Ibid.*

<sup>1253</sup> Recent studies have estimated an outflow of capital from poorer countries of more than \$1.2 trillion in 2008, of which around \$50 billion would be proceeds of corruption. *See* Financial Action Task Force, *Laundering the Proceeds of Corruption*, *supra* note 1236, at 9; Theodore S Greenberg et al, *Stolen Asset Recovery: Politically Exposed Persons--A Policy Paper on Strengthening Preventive Measures* (Policy Paper, Stolen Asset Recovery Initiative/World Bank, 2009) xiii, 3-4, available at <http://siteresources.worldbank.org/EXTSARI/Resources/5570284-1257172052492/PEPs-ful.pdf>; Dev Kar and Karly Curcio, *Illicit Financial Flows from Developing Countries: 2000-2009--Update with a Focus on Asia*

matter.<sup>1254</sup> As such, a separate chapter in UNCAC has established the provisions for asset recovery.<sup>1255</sup> A balance was sought between effective asset recoveries, along with procedural safeguards. UNCAC thus aims to strike a fragile balance, on the one hand, it contains detailed and strong anti-corruption provisions, which developed countries requested; while on the other hand, developing countries were willing to accept these provisions in return for strong cooperation and asset recovery provisions. The latter were acceptable to developed countries on the condition that they were subject to sufficient procedural safeguards.

The Convention facilitates asset recovery by requiring that state parties amend their laws to permit the confiscation of the proceeds of crime and to revise their laws so that bank secrecy is no longer absolute. Article 31(7) of UNCAC provides that, “each State Party shall empower its courts or other competent authorities to order that bank, financial or commercial records be made available or seized. A State Party shall not decline to act ... on the grounds of bank secrecy.”<sup>1256</sup> It is not surprising considering the balances that were made that asset recovery in the Convention has been met with mixed sentiments. Many consider the provisions to be ground breaking.<sup>1257</sup> The Convention also provides mandatory provisions, which empower states to recover property through civil action or international cooperation.<sup>1258</sup> However, the enforcement of the Convention in international law remains largely incidental to international cooperation. While the Vienna Convention on the Law of Treaties requires states that ratify treaties to oblige by the treaty under the

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I (Report, Global Financial Integrity, January 2011) available at [http://www.gfintegrity.org/storage/gfip/documents/reports/IFF2010/gfi\\_iff\\_update\\_report-web.pdf](http://www.gfintegrity.org/storage/gfip/documents/reports/IFF2010/gfi_iff_update_report-web.pdf); Raymond W Baker, *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System* 172 (2005). The Stolen Asset Recovery Initiative's ('StAR') estimates indicate that around US\$5 billion has been recovered in the period 1995 to 2010: Stolen Asset Recovery Initiative, *Frequently Asked Questions* (2013), <http://star.worldbank.org/star/about-us/frequently-asked-questions>.

<sup>1254</sup> Webb, *supra* note 1226, at 207.

<sup>1255</sup> UNCAC, *supra* note 1223, art 51 (“The return of assets pursuant to this chapter is a fundamental principle of this Convention, and States Parties shall afford one another the widest measure of cooperation and assistance in this regard”).

<sup>1256</sup> *Ibid.* art. 31(7).

<sup>1257</sup> Webb, *supra* note 1226, at 209.

<sup>1258</sup> UNCAC, *supra* note 1223, arts. 53-54.



doctrine of *pacta sunt servanda*, no reliable body of enforcement exists in international law.<sup>1259</sup>

### **The World Bank**

The World Bank is one of the global frontrunners in the fight against corruption and was the first development finance organization to implement a comprehensive anti-corruption regime.<sup>1260</sup> The Bank has changed its role from a self-described apolitical institute to a bank that actively supports the progression of public institutes and the strengthening of governments.<sup>1261</sup> “Between 2000 and 2004, lending to promote economic reforms fell by 14 percent a year, but lending to improve governance rose by 11 percent. In the 2004 fiscal year the Bank committed 25 percent of its lending to law and public administration.”<sup>1262</sup> Today, the Bank has determined corruption to be one of the greatest hurdles to economic and social development and has identified five elements of an effective anticorruption strategy: increase political accountability, strengthen civil society participation, create a competitive private sector, implement institutional restraints on power, and improve public sector management.<sup>1263</sup>

In 2006, the World Bank proposed a new strategy on governance and anti-corruption.<sup>1264</sup> The Bank recognized that the issue of grand corruption and noted that it is an issue that is harder to address than administrative corruption.<sup>1265</sup> Similar to UNCAC, the Bank listed its technical assistance for asset recovery as fundamental to its global approach to the problem of corruption.<sup>1266</sup> From this, in 2007, the World Bank announced

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<sup>1259</sup> Vienna Convention on the Law of Treaties, art. 36, May 23, 1969, 1155 U.N.T.S 331; see also Webb, *supra* note 1226, at 222.

<sup>1260</sup> Parthapratim Chanda, The Effectiveness of the World Bank's Anti-Corruption Efforts: Current Legal and Structural Obstacles and Uncertainties, 32 DENV. J. INT'L L. & POL'Y 315, 318 (2004).

<sup>1261</sup> A Regime Changes: Paul Wolfowitz at the World Bank, THE ECONOMIST, June 2, 2005, <http://www.economist.com/node/4032601>.

<sup>1262</sup> *Ibid.*

<sup>1263</sup> The World Bank, Anti-corruption, available at <http://go.worldbank.org/EWYJ9SL5X0>.

<sup>1264</sup> Strengthening Bank Group Engagement on Governance and Anticorruption, Sept. 8, 2006, available at <http://www.worldbank.org/html/extdr/comments/governancefeedback/gacpaper.pdf>.

<sup>1265</sup> *Ibid.*

<sup>1266</sup> *Ibid.*

the Stolen Asset Recovery (StAR) Initiative, a joint project between the Bank and the United Nations Office on Drugs and Crime.<sup>1267</sup>

The StAR Initiative seeks to implement the UNCAC by aiding countries in building capacity for mutual legal assistance, creating partnerships to share information and expertise, and establishing a joint funding vehicle to provide assistance to states for asset recovery cases.<sup>1268</sup> The Initiative established four primary tasks for the project which include: to build institutional capacity in developing countries, to strengthen the integrity of financial markets (especially by assuring that financial centers are in compliance with anti-money laundering legislation), to assist the asset recovery process of developing countries, and to monitor the use of recovered assets.<sup>1269</sup> StAR and the concept of asset recovery soon led to a number of G-20 statements and commitments.<sup>1270</sup> As a result, some of the most influential countries and national leaders in the world have signed on to the link between development, poverty, and fighting corruption with stolen asset recovery, thereby elevating asset recovery to the forefront of the development agenda.<sup>1271</sup>

StAR aims to assist client countries throughout each stage of the asset recovery process, which can prove to be very complex and challenging, particularly for developing countries with no prior experience in stolen asset recovery.<sup>1272</sup> StAR aids countries in initiating asset recovery cases, by guiding them through the initial steps that are required to launch a legal proceeding. It also advises countries in how to overcome legal and

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<sup>1267</sup> Press Release, World Bank, World Bank and UNODC to Pursue Stolen Asset Recovery, 2008/061/PREM (Sept. 18, 2007), available at <http://go.worldbank.org/08LGHMJT10>; see also StAR, About Us, [http://www1.worldbank.org/finance/star\\_site/about-us.html](http://www1.worldbank.org/finance/star_site/about-us.html) (reiterating that asset recovery is undertaken by states using legal procedures and that StAR does not investigate cases, prosecute or request mutual legal assistance).

<sup>1268</sup> *Ibid.*

<sup>1269</sup> See Stolen Asset Recovery Initiative: Challenges, Opportunities, and Action Plan, available at, <http://siteresources.worldbank.org/NEWS/Resources/Star-rep-full.pdf>.

<sup>1270</sup> Vlasic & Cooper, *supra* note 1200, at 18.

<sup>1271</sup> The G20 2010 emphasizes asset recovery in its Anti-Corruption Action Plan. See Government of Canada, Foreign Affairs and International Trade, The G20 Seoul Summit Leader's Declaration (Nov. 22, 2010), [http://www.canadainternational.gc.ca/g20/summitsommet/2010/g20\\_seoul\\_declaration.aspx?Langeng & menuid=41&menu=L&view=d](http://www.canadainternational.gc.ca/g20/summitsommet/2010/g20_seoul_declaration.aspx?Langeng & menuid=41&menu=L&view=d). See also Government of Canada, Annex III - G20 Anti-Corruption Action Plan (Nov. 22, 2010), available at [http://www.canadainternational.gc.ca/g20/summitsommet/2010/G20\\_seoul\\_annex-annexes%203.aspx?view=d](http://www.canadainternational.gc.ca/g20/summitsommet/2010/G20_seoul_annex-annexes%203.aspx?view=d).

<sup>1272</sup> StAR, About Us, *supra* note 1267.

operational barriers in order for the countries to better collaborate with countries where the assets are located. StAR also plays the role of facilitator for countries in their discussions with financial institutions where assets may be hidden. Additionally, StAR connects officials in complainant countries with practitioners, law enforcement officials and prosecutors in financial center. StAR also assists in building institutional capacity by helping countries develop legislation to strengthen their legal and regulatory systems for recovering stolen assets and combating corruption. Through training workshops and seminars, StAR equips law enforcement and financial intelligence practitioners, as well as investigative judges and prosecutors, with skills and knowledge on topics such as asset tracking and international legal cooperation.

As an integral part of the Bank's overall governance and anti-corruption work, the StAR Initiative plays a critical complementary role in the Bank's efforts in the area of governance and anti-corruption. Such efforts include the Bank's involvement in the criminal justice sector, which is not precluded under the Bank's mandate, provided that proposed interventions are grounded in an appropriate and objective economic rationale and are structured so as to avoid interference in the political affairs of a member country. Successful asset recovery has an immediate and direct economic benefit through the recovery of funds that would otherwise have been lost. It is a vital component in deterring corruption, which is widely recognized as a major obstacle to development and growth. Furthermore, it promotes greater accountability and transparency and has significant potential benefits, such as supporting institutional reform and the effective functioning of the rule of law.

Considering the "political prohibition" in the Bank's Articles of Agreement,<sup>1273</sup> it has been recommended that it use a risk management approach to political interference issues. This includes a case-by-case assessment of the risks and the measures that it may utilize in order to mitigate those risks. Cases related to stolen asset recovery are generally set against a background of partisan politics, forming part of a larger struggle between rival political forces. Direct support for specific cases would be considered as the sort of interference in the internal political affairs of a member country that the political

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<sup>1273</sup> The World Bank Articles of Agreement, Art. IV, § 10.

prohibition is meant to proscribe. However, this does not mean the Bank can never support specific cases.<sup>1274</sup> Currently, StAR is involved in Arab countries in transition, assisting Egypt, Libya, and Tunisia in their efforts to return assets from various foreign jurisdictions. The focus in these countries is on the need for early action and strategic planning.<sup>1275</sup>

In 2012, the Bank went live with a database of corruption cases, which includes over 150 large-scale corruption cases. The database was created as part of the U.N.-led Working Group of states who are signatories to the U.N. Convention Against Bribery.<sup>1276</sup> Another related database was launched in 2011, and is known as The Puppet Masters Database of Grand Corruption Cases. The World Bank's searchable database is a consolidated repository of three U.N., World Bank, and UNODC databases, including The Puppet Masters, Asset Recovery Watch, and World Bank debarment actions. The cases involve the misuse of at least one legal entity or legal arrangement to obscure its beneficial owner(s) and conceal the origin or destination of stolen assets.<sup>1277</sup>

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<sup>1274</sup> StAR Initiative,

<http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTLAWJUSTICE/0,,contentMDK:22940228~menuPK:9203924~pagePK:148956~piPK:216618~theSitePK:445634,00.html> (“There may be cases where it is beyond doubt that there is little or no potential political implications to a particular case. There may also be cases where counter-considerations weigh in favor of support: in cases involving the diversion of Bank loan proceeds, for example, consideration of the political prohibition must be weighed against the Bank’s fiduciary duty under the Articles to ensure the proper use of loan proceeds. And there are activities ancillary or preparatory to potential specific cases that the Bank may support without incurring undue political interference risk, for example, forensic audits, financial analysis and other forms fact-finding, as well as briefings on relevant legal requirements, that would inform a decision whether or not to pursue a case.”)

<sup>1275</sup> StAR, About Us, *supra* note 1267.

<sup>1276</sup> See U.N. Conference of the State Parties to the United Nations Convention Against Corruption, Vienna, Austria, Aug. 30-31, 2012, Overview of Progress Made in the Implementation of Conference Resolution 4/4 and the Recommendation of the Working Group, U.N. Doc. CAC/COSP/WG.2/2012 (June 27, 2012). See also StAR Corruption Cases Search Center, Stolen Asset Recovery Initiative, [http://star.worldbank.org/corruption-cases/assetrecovery/?f\[0\]=bundle%2Fpuppet\\_masters](http://star.worldbank.org/corruption-cases/assetrecovery/?f[0]=bundle%2Fpuppet_masters) (last visited Feb. 17, 2013) [hereinafter StAR Database].

<sup>1277</sup> *Ibid.* at 27-28.

## Stolen Asset Recovery in the United States and the United Kingdom

### Asset Recovery in the United States

It has been said that “any discussion of international measures against corruption and bribery must begin with the United States.”<sup>1278</sup> In the late 1960s and 1970s, the U.S. was afflicted by corruption scandals. In 1977, the U.S. Congress took the forefront and adopted the Foreign Corrupt Practices Act (“FCPA”), the first law prohibiting transnational bribery.<sup>1279</sup> The FCPA, which contains far-reaching jurisdictional provisions,<sup>1280</sup> served as the benchmark for international efforts to combat corruption of foreign officials.

The FCPA has two sets of provisions, those targeting anti-bribery<sup>1281</sup> and accounting provisions.<sup>1282</sup> The anti-bribery provisions provide the basis for prosecutions of individuals and corporations involved in bribing foreign officials, whereas the accounting provisions concern transparency and the reporting of payments made to foreign officials. According to the FCPA, it is unlawful for U.S. persons and companies to pay bribes to foreign government officials (non-U.S.) for the purpose of obtaining or retaining business or for any improper advantage.

The FCPA affords for a classic, active and personality-based jurisdiction in which it subjects all “United States person[s]” to the FCPA, even if their acts of bribing foreign officials have no nexus with the territory of the U.S.<sup>1283</sup> Additionally, the FCPA also applies to persons or entities that are organized under the laws of a U.S. state or have their principal place of business in the U.S., even if they are not U.S. nationals (this harkens to the law’s so-called “domestic concerns”).<sup>1284</sup> Nevertheless, jurisdiction will not be

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<sup>1278</sup> Peter W. Schroth, National and International Constitutional Law Aspects of African Treaties and Laws Against Corruption, 13 *TRANSNAT'L L. & CONTEMP. PROBS.* 83, 87 (2003).

<sup>1279</sup> Foreign Corrupt Practices Act of 1977, 15 USC § 78dd-1 (1977) (“FCPA”).

<sup>1280</sup> *Ibid.* §§ 78dd-1(g), 78dd-2(i).

<sup>1281</sup> *Ibid.* §§ 78dd-1, 78dd-2, 78dd-3.

<sup>1282</sup> *Ibid.* § 78m

<sup>1283</sup> *Ibid.* § 78dd-1(g), 78dd-2(i).

<sup>1284</sup> *Ibid.* § 78dd-2(h)(1).

established with regards to these persons if process cannot be served on them (absence of in personal jurisdiction).<sup>1285</sup>

Under the FCPA, the U.S. is able to have far-reaching jurisdictional claims. This is due to the fact that the provisions permit U.S. enforcement agencies to bring claims against foreign issuers for the bribery of foreign officials without any nexus with the US (except the listing of stock on a U.S. exchange),<sup>1286</sup> and also (in respect of foreign bribery) against foreign persons whose stock is not even listed in the US, on the sole basis that some act furthering bribery has a link with the U.S.<sup>1287</sup> Accordingly, it is no overstatement to find that U.S. jurisdiction over corruption is potentially quasi-universal.

Possibly the most important substantive provision of the FCPA is the section that defines unlawful conduct. This provision states that it is “shall be unlawful . . . to make use of the mail or any means or instrumentality of interstate commerce corruptly in furtherance of an offer, payment, promise to pay, or authorization of payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value.”<sup>1288</sup> In order for these offers, payments, or promises to be unlawful, they must be provided to at least one of three categories of persons: foreign officials,<sup>1289</sup> foreign political parties or candidates, or third persons who may act as intermediaries “while knowing” that the intermediaries would offer all or part of such benefits to the former two categories.<sup>1290</sup> The punishable acts must also be made for purposes of:

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<sup>1285</sup> See *United States v Bodmer*, 342 F Supp 2d 176, 192-3 (SDNY, 2004).

<sup>1286</sup> FCPA, § 78dd-1(g).

<sup>1287</sup> *Ibid.* § 78dd-2(i).

<sup>1288</sup> *Ibid.* §§ 78dd-1(a), 78dd-2(a).

<sup>1289</sup> The Act defines foreign officials to include: “[a]ny officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization.” *Id.* § 78dd-1(f)(1).

<sup>1290</sup> See *ibid.* §§ 78dd-1(a)(1) - (3), 78dd-2(a)(1)-(3). According to the Act:

A person's state of mind is “knowing” with respect to conduct, a circumstance, or a result if (i) such person is aware that such person is engaged in such conduct, that such circumstance exists, or that such result is substantially certain to occur; or (ii) such person had a firm belief that such circumstance exists or that such result is substantially certain to occur. (B) When knowledge of the existence of a particular circumstance is required for an offence, such knowledge is established if a person is aware of a high probability of the existence of such circumstance, unless the person actually believes that such circumstance does not exist. *Id.* § 78dd-2(h)(3)(A)-(B).

(A) (i) influencing any act or decision of such foreign official in his official capacity, (ii) inducing such foreign official to do or omit to do any act in violation of the lawful duty of such official, or (iii) securing any improper advantage; or

(B) inducing such foreign official to use his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality, [i]n order to assist such issuer [or domestic concern] in obtaining business for or with, or directing business to, any person.<sup>1291</sup>

The FCPA sets severe civil and criminal penalties for violations of any of the provisions by any natural or legal persons subject to its authority.<sup>1292</sup> If enforcement authorities are able to prove wilful disregard of the statute, penalties for natural persons may include imprisonment for up to twenty years.<sup>1293</sup>

According to the United States, providing remedies for transnational public bribery as a consistent and sustained practice furthers U.S. foreign policy goals underlying the FCPA.<sup>1294</sup> Further, as observed by a U.S. Senate committee report regarding the enactment of the FCPA, foreign public bribery undermines “the image of American democracy abroad.”<sup>1295</sup> In this sense, by providing a forum for foreign victims to vindicate their rights and hold corporations accountable would protect the integrity and safeguard the image of the United States. Transnational access to remedies for transnational public bribery is therefore justified on principled and pragmatic grounds. However, legal frameworks internationally and in the United States have failed to adequately meet this need. Although there are still issues that should be reformed, between 2002 and 2008, FCPA enforcement

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<sup>1291</sup> Ibid. §§ 78dd-1(a)(1)-(3), 78dd-2(a)(1)-(3).

<sup>1292</sup> See generally id. §§ 78dd-2(g), 78ff.

<sup>1293</sup> Ibid. § 78ff(a).

<sup>1294</sup> See *Lamb v. Phillip Morris, Inc.*, 915 F.2d 1024, 1029 (6th Cir. 1990) (holding that the FCPA was “designed to protect the integrity of American foreign policy”).

<sup>1295</sup> S. Rep. No. 95-114, at 3 (1977), reprinted in 1977 U.S.C.C.A.N. 4098, 4101.

resulted in over “\$1.2 billion in settlements and penalties involving more than 30 countries.”<sup>1296</sup>

A limitation of the FCPA is that it does not expressly permit any private right of action. During the drafting of the FCPA, a proposed text included a private right of action “for any person who could establish actual damage to his business resulting from illegal payments made by a competitor.”<sup>1297</sup> This idea was regarded as having merit, but the proposed text was found to be too ambiguous.<sup>1298</sup> A Senate committee requested that the text be revised, but it seems that no follow-up action was taken and the provision never became endorsed by the Senate.<sup>1299</sup> The Supreme Court and several lower courts have also held that the FCPA provides no implied private right of action, on grounds that this was not the legislative intent and would be inconsistent with the legislative scheme. Experts, academics, and commentators have argued for an FCPA amendment to include a private right of action though.<sup>1300</sup> Despite the limitations, the Department of Justice has also established the protocol for Asset Recovery Initiative to aid in the recovery of proceeds of public bribery that have been laundered into or through the United States “for the benefit of the people of the country from which it was taken.”<sup>1301</sup> On June 28, 2012, the first forfeiture judgment was obtained under the Initiative with the forfeiture of US \$401,931 in assets traceable to former Nigerian Governor of Bayelsa State, Diepreye Solomon Peter

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<sup>1296</sup> Matt A. Vega, *Balancing Judicial Cognizance and Caution: Whether Transnational Corporations Are Liable for Foreign Bribery under the Alien Tort Statute*, 31 *MICH. J. INT'L L.* 385, 387 (2010).

<sup>1297</sup> S. Rep. No. 94-1031 (1976).

<sup>1298</sup> *Ibid.*

<sup>1299</sup> S. Rep. No. 95-144 (1977).

<sup>1300</sup> See, e.g., Richard L. Cassin, *The FCPA Is No Private Matter*, FCPA Blog (Mar. 2, 2008), <http://tinyurl.com/mx23f6x>; Paul D. Carrington, *Enforcing International Corrupt Practices Law*, 32 *MICH. J. INT'L L.* 129, 154 (2010) (advocating for amending the FCPA to permit private enforcement of its anti-bribery provisions by foreign citizens in US courts, on behalf of their governments whose officials were bribed).

<sup>1301</sup> Press Release, U.S. Dep't of Justice, *Department of Justice Seeks to Recover More Than \$70.8 Million in Proceeds of Corruption from Government Minister of Equatorial Guinea* (Oct. 25, 2011), available at <http://tinyurl.com/3buj6ce>.



Alamieyeseigha.<sup>1302</sup> Since 2004, the United States has forfeited and returned over \$168 million to victims abroad.<sup>1303</sup>

### **Asset Recovery in the United Kingdom**

In the United Kingdom, corruption offences are treated under both legal statutes and common law. And while the United States has been the historic frontrunner in the criminalization and prosecution of foreign corruption, the U.K. was long considered as lagging behind. In 2005, the Organization for Economic Cooperation and Development (OECD) issued a report criticizing the U.K.'s approach to the corruption offences, arguing that too little had been done to update the legal framework.<sup>1304</sup> Even as late as 2008, OECD still had to address the issue.<sup>1305</sup> The U.K. did criminalize the corruption of foreign officials by U.K. nationals or companies since 2001,<sup>1306</sup> yet reliance on a strictly circumscribed active personality principle did nothing to combat foreign corruption by UK-based foreign nationals.<sup>1307</sup> As a means to address the criticism, in 2010, the U.K. Bribery Act was enacted and came into force in July 2011.<sup>1308</sup> However, so far no “extraterritorial” prosecution has been brought under the Bribery Act.<sup>1309</sup>

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<sup>1302</sup> Press Release, U.S. Dep't of Justice, Department of Justice Forfeits More Than \$400,000 in Corruption Proceeds Linked to Former Nigerian Governor (June 28, 2012), <http://www.justice.gov/opa/pr/2012/June/12-crm-827.html>.

<sup>1303</sup> U.S. Dep't of State, U.S. Asset Recovery Tools & Procedures: A practical Guide for International Cooperation (2012) available at, <http://tinyurl.com/n64mbxe>.

<sup>1304</sup> Report on the Application of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the 1997 Recommendation on Combating Bribery in International Business Transactions. OECD, 17 March 2005; available at <http://www.oecd.org/dataoecd/62/32/34599062.pdf>.

<sup>1305</sup> Working Group on Bribery in International Business Transactions, Organization for Economic Co-Operation and Development, 'United Kingdom: Phase 2bis-- Report on the Application of the OECD Convention on Combating Bribery of Foreign Public Officials on International Business Transactions and the 1997 Recommendation on Combating Bribery in International Business Transactions' (Report, Directorate for Financial and Enterprise Affairs, Organization for Economic Co-Operation and Development, 16 October 2008) <http://www.oecd.org/dataoecd/23/20/41515077.pdf>

<sup>1306</sup> Anti-Terrorism, Crime and Security Act 2001 (UK) c 24, s 109 (which came into force on 14 December 2001).

<sup>1307</sup> F. Joseph Warin, Charles Falconer and Michael S Diamant, *The British are Coming: Britain Changes Its Law on Foreign Bribery and Joins the International Fight against Corruption*, 46 Texas Int'l L. J. 1, 5 (2010).

<sup>1308</sup> Bribery Act, 2010, c.23 (U.K.).

<sup>1309</sup> For a discussion of the first domestic prosecution brought (namely that of Munir Patel) and fine imposed for failings in anti-bribery and corruption systems and controls (on Willis Limited) under the Bribery Act (UK), see Steven Pitt and Barney Connell, *A Year in the Life of the UK Bribery Act*, in Sidley Austin LLP, Insurance and Reinsurance Law Report (2012) 35, 38-41 [http://www.sidley.com/files/upload/2012\\_IRLR\\_UK%20BRIBERY\\_ACT.pdf](http://www.sidley.com/files/upload/2012_IRLR_UK%20BRIBERY_ACT.pdf).

The Bribery Act contains three main jurisdictional provisions.<sup>1310</sup> Section 12 is the most forthright, providing for jurisdiction “if any act or omission which forms part of the offence takes place in ... the United Kingdom,” such as territorial jurisdiction.<sup>1311</sup> This section provides the U.K. jurisdiction over a person or entity bribing a foreign public official if the person or entity has a close connection with the UK, even if the act or omission at issue does not take place in the U.K.<sup>1312</sup> The Act expands on this further in 7, however, by criminalizing the failure of a “relevant commercial organization” to prevent foreign bribery, giving the Act a long arm reach.<sup>1313</sup> It not only defines a “relevant commercial organization” as “a body which is incorporated under the law of any part of the United Kingdom and which carries on a business (whether there or elsewhere)”<sup>1314</sup> or as “a partnership which is formed under the law of any part of the United Kingdom and which carries on a business (whether there or elsewhere),”<sup>1315</sup> but also as “any other body corporate (wherever incorporated) which carries on a business, or part of a business, in any part of the United Kingdom”<sup>1316</sup> or as “any other partnership (wherever formed) which carries on a business, or part of a business, in any part of the United Kingdom.”<sup>1317</sup>

Thus, the U.K. can assert jurisdiction over a failure to prevent foreign corruption under the Bribery Act (which also extends to corruption of private persons) under an extended active personality principle and on the basis of territorial links. It will fall to the relevant enforcement agency to determine what territorial link is sufficient for UK jurisdiction to be triggered, but a wide interpretation of territoriality, similar to the US, is not excluded. The potential jurisdictional scope of the Bribery Act becomes amplified if “relevant commercial organization[s]” (to which the Act applies) included foreign

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<sup>1310</sup> Bribery Act (UK) c 23, ss 6, 7, 12.

<sup>1311</sup> Ibid.

<sup>1312</sup> Ibid.; A person or entity has a close connection for example, when that person or entity, was a British citizen, was an individual ordinarily resident in the UK, or a body incorporated under the law of any part of the UK. For an overview of all instances of ‘close connection’: see id. s 12(4).

<sup>1313</sup> Ibid. s 7.

<sup>1314</sup> Ibid. s 7(5)(a).

<sup>1315</sup> Ibid. s 7(5)(c).

<sup>1316</sup> Ibid. s 7(5)(b).

<sup>1317</sup> Ibid. s 7(5)(d).

subsidiaries of U.K. companies, or foreign companies in which U.K. companies have an interest.<sup>1318</sup>

The U.K. Bribery Act creates “four categories of offences: (1) bribing another person; (2) taking bribes; (3) bribing foreign public officials; and (4) failure of a commercial organization to prevent bribery. With its expansive scope and jurisdictional reach, the Bribery Act significantly reshapes the UK's anti-corruption regime.”<sup>1319</sup> Additionally, “[p]enalties for violations of the Bribery Act include unlimited fines for companies and individuals and a term of imprisonment of up to 10 years for individual defendants.”<sup>1320</sup> For financial service firms subject to regulation authority by the U.K.'s FSA (recently replaced by the FCA and PRA), “adequate internal controls reasonably designed to prevent bribery of non-U.K. officials are not just an affirmative defence to the UKBA's so-called corporate offence, but an affirmative requirement for all firms authorized by the FSA in accordance with the Financial Services and Markets Act of 2000 (“FSMA”).”<sup>1321</sup> Likewise, “in a short note, the FSA reminded FSA-authorized firms that underlying acts of making corrupt payments or an offer to make corrupt payments need not exist for a company to be subject to regulatory action for lacking sufficient anti-bribery internal controls.”<sup>1322</sup> The FSA note, in its entirety, follows:

“Corruption and bribery are criminal offences under the Bribery Act 2010, which came into force on 1 July 2011. The Act consolidated and replaced previous anti-corruption legislation and introduced a new offence of commercial organizations failing to prevent bribery. Firms have a full defence for this offence if they can

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<sup>1318</sup> Warin, Falconer and Diamant, *supra* note 1307, at 29-30 (arguing that in this respect “section 7's requirements could effectively extend to even the remotest corners of a global organization”).

<sup>1319</sup> Covington & Burling LLP, Anti-Corruption Mid-Year Review (July 2011), available at <http://www.cov.com/files/Publication/01a3d761-b8ca-421f-9932-b0fef03c4219/Presentation/PublicationAttachment/68ac553e-2122-49fa-b270-b38b69ff5215/Anti-Corruption%20Mid-Year%20Review%20-%20Beijing.pdf>.

<sup>1320</sup> Gibson Dunn, 2010 Year-End FCPA Update (Jan. 3, 2011), available at <http://www.gibsondunn.com/publications/pages/2010Year-EndFCPAUpdate.aspx>.

<sup>1321</sup> Karolos Seeger & Matthew H. Getz, The U.K. FSA Reminds Financial Services Firms of Anti-Corruption Compliance Obligations, FCPA Update (Debevoise & Plimpton LLP, New York, NY), Sept. 2011, at 7, available at [http://www.debevoise.com/files/Publication/ccf8c29f-9f86-47ac-95f5-05c65c607046/Presentation/PublicationAttachment/a83e70dc-a1b5-4d6d-ac22-2c7034d175b5/FCPA\\_Update\\_Sept\\_2011.pdf](http://www.debevoise.com/files/Publication/ccf8c29f-9f86-47ac-95f5-05c65c607046/Presentation/PublicationAttachment/a83e70dc-a1b5-4d6d-ac22-2c7034d175b5/FCPA_Update_Sept_2011.pdf).

<sup>1322</sup> *Ibid.*

show that they had adequate procedures designed to prevent bribery. The Government has published guidance on these procedures.”

There are various key differences that exist between the U.K. and U.S. anti-bribery laws. The U.K. Bribery Act goes farther than the FCPA, criminalizing the payment, offer, or promise of a bribe, as well as the request, acceptance, or agreement to accept a bribe.<sup>1323</sup> The U.S. law only criminalizes the former.<sup>1324</sup> The U.K. law also contains a corporate offence of failing to prevent bribery and contains no facilitating payment exception, as is found in the FCPA.<sup>1325</sup> However, the potential penalties under the Bribery Act may generally be considered far more draconian than those under the FCPA.<sup>1326</sup>

However, despite these differences, the U.K. still seems to lack in its ability to aid in asset recovery.<sup>1327</sup> In the 2010 StAR/OECD study revealed that between 2006 and 2009, the U.K. froze US\$229.6 million (18.7 per cent of the total frozen in all 30 OECD countries), and had recovered and returned \$2.2 million (0.8 per cent of the total returned).<sup>1328</sup> The report indicates that the U.K. appears to have underperformed in comparison to the in terms of returning what small seizure was achieved and returning it

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<sup>1323</sup> Jones Day, A New Weapon in the Arsenal for the Fight Against Corruption: The U.K. Bribery Act of 2010 (Apr. 2010), available at <http://www.jonesday.com/files/Publication/79cd836f-6829-4b74-bc38-f0cff1ec49ec/Presentation/PublicationAttachment/f77034b9-035e-45a3-bf41-f11708369196/New%20Weapon.pdf>.

<sup>1324</sup> Criminal Div. of the U.S. Dep't of Justice & the Enforcement Div. of the U.S. Secs. and Exch. Comm'n, A Resource Guide to the U.S. Foreign Corrupt Practices Act 10 (Nov. 14, 2012) available at <http://www.justice.gov/criminal/fraud/fcpa/guide.pdf>.

<sup>1325</sup> Jones Day, *supra* note 1323.

<sup>1326</sup> See generally Robert F. Amaee & John P. Rupp, Keeping Current: Anti-Corruption, The Bribery Act 2010 Guidance: Countdown to Implementation, *Bus. L. Today* (Am. Bar Assoc., Chicago, Ill.), June 2011, at 1, available at <http://www.cov.com/files/Publication/b5bdef2d-c3ef-4d5d-94de-c96458fac452/Presentation/PublicationAttachment/ff24dd9a-0520-41fc-a9eb-cb7b40205263/Anti-Corruption%20-%20The%20Bribery%20Act%202010%20Guidance%20-%20Countdown%20to%20Implementation.pdf>.

<sup>1327</sup> See Transparency International, Closing Down the Safe Havens: Ending Impunity for Corrupt Individuals by Seizing and Recovering their Assets in the U.K. 6, available at <http://www.transparency.org.uk/publications/15-publications/809-closing-down-the-safe-havens/809-closing-down-the-safe-havens> [hereinafter Closing Down the Safe Havens] (“The UK is among the leading jurisdictions in the world in terms of recognizing the problem [of laundering stolen money]; but still not doing nearly enough to resolve it”)

<sup>1328</sup> Selected OECD Activities on Asset Recovery, Illicit Flows and Financial Crime, [http://www.unodc.org/documents/treaties/UNCAC/WorkingGroups/workinggroup2/2011-August-25-26/Presentations/Achim\\_Pross\\_and\\_Kjetil\\_Hanssen\\_OECD.pdf](http://www.unodc.org/documents/treaties/UNCAC/WorkingGroups/workinggroup2/2011-August-25-26/Presentations/Achim_Pross_and_Kjetil_Hanssen_OECD.pdf)

to victims and the origin states. Nevertheless, the U.K. has strong legal tools in non-conviction based asset forfeiture (“NCBAF”).<sup>1329</sup> However, considering the low adoption of NCBAF around the world, the U.K. may lack the necessary mutual legal assistance from other jurisdictions to take forward NCBAF cases with international dimensions.<sup>1330</sup>

### **Advocating for Civil Remedies in Asset Recovery**

Clearly there are practical difficulties of recovering the proceeds of corruption, both from within the U.S. and U.K. and elsewhere. These difficulties have become starker as a result of the Arab Spring and asset recovery initiatives in the wake of regime changes across the region in 2011 and 2012.<sup>1331</sup> It has been over two years since longstanding autocratic regimes in the region fell, but, since that time, there has been little concrete progress globally in the repatriation of stolen funds.<sup>1332</sup> Although criminal prosecution and non-conviction based asset forfeiture have seemed to become the preferred methods for the U.S. and U.K. governments, taking cases on in a private civil route can possibly prove to be a better option to secure and recover stolen assets.<sup>1333</sup> To the World Bank and the StAR initiative, civil actions are an underused method in achieving the fight against corruption. As can be seen, the proceeds of corruption can be recovered through either criminal or civil proceedings. Criminal proceedings require a prior criminal conviction which focuses on the corrupt individual. When a criminal conviction is impossible (for instance, where the corrupt individual has passed away or enjoys immunity) or conviction is just unattainable, civil proceedings may be a practical alternative. Civil proceedings focus on the goods that have been stolen through corrupt acts, rather than on the corrupt individual. Hence,

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<sup>1329</sup> See Closing Down the Safe Havens, *supra* note 1327, at 8 (noting that the standard of proof for non-conviction based asset forfeiture is based on the balance of probabilities which is a lower standard than beyond a reasonable doubt required for criminal proceedings).

<sup>1330</sup> *Ibid.*

<sup>1331</sup> *Ibid.*

<sup>1332</sup> *Ibid.*

<sup>1333</sup> One practical impediment to the forfeiture of the proceeds of corrupt acts is the requirement of quantifying those proceeds. Identifying the value of the bribe is one step, but the actual benefit of the bribery for the bribe-giver may be several times the amount of the bribe. A joint OECD/Stolen Asset Recovery Initiative report aims to address such difficulties by providing very detailed guidance on the calculation of the actual benefit amounting from a bribe. Jan Wouters et. al., *The International Legal Framework Against Corruption: Achievements and Challenges*, 14 *Melb. J. Int'l L.* 205, 264 (2013)

property can be seized through civil proceedings without the user or owner being convicted for the initial corrupt act.<sup>1334</sup>

The basis behind civil asset recovery lies in the seeming ability of leaders of organized crime gangs to distance themselves from detectable criminal behaviour by delegating responsibility for the implementation of illegal acts, thereby preventing prosecution in the conventional way.<sup>1335</sup> The same premise can be applied to corrupt leaders who steal from their country and are able to escape corrupt criminal charges or distance themselves from their deeds.

The international mechanisms for asset recovery allow states to claim civil damages in corruption cases and the state parties, and their respective agencies, are empowered to bring such claims.<sup>1336</sup> Article 35 of the UNCAC requires state parties to take necessary measures and establish appropriate mechanisms to ensure that entities or persons who have suffered damage as a result of an act of corruption have the right to initiate legal action to obtain compensation.<sup>1337</sup> Furthermore, Chapter V of the Convention requires states parties to take measures to restrain, seize, confiscate, and return the proceeds of corruption, including civil proceedings and remedies. Article 53 of the UNCAC requires states to permit other states “to initiate civil action in (their) courts to establish title to or ownership of property acquired through the commission of an offence established in accordance with the Convention.”<sup>1338</sup>

Similarly, there has been regional recognition of the importance of civil proceedings to combat corruption as can be seen through the Council of Europe Civil Law

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<sup>1334</sup> An example is the fourth (formerly third) FATF recommendation, entitled Confiscation and Provisional Measures': FATF Recommendations, supra note 1236, 12. See also Financial Action Task Force, Best Practices: Confiscation (Recommendations 3 and 38) (Guidance Document, 19 February 2010) 7 ; Theodore S Greenberg et al, Stolen Asset Recovery: A Good Practices Guide for Non-Conviction-Based Asset Forfeiture (Guidance Document, Stolen Asset Recovery Initiative, World Bank, 5 January 2009).

<sup>1335</sup> Liz Campbell, The Recovery of "Criminal" Assets in New Zealand, Ireland and England: Fighting Organized and Serious Crime in the Civil Realm, 41 Vict U. Wellington L Rev. 15, 16 (2010)

<sup>1336</sup> See UNCAC, supra note 1223, art. 34 (emphasizing the importance of civil proceedings and remedies in the fight against corruption).

<sup>1337</sup> Ibid. art. 35.

<sup>1338</sup> Ibid. art. 53(a)

Convention. Article 1 of the Council of Europe Civil Law Convention on Corruption<sup>1339</sup> requires state parties to enable “persons,” natural or legal, who have suffered damage as a result of corruption to defend their rights and obtain damages.<sup>1340</sup> Article 8§2 of the same convention also requires that “each Party shall provide in its internal law for the possibility for all parties to a contract whose consent has been undermined by an act of corruption to be able to apply to the court for the contract to be declared void, notwithstanding their claim for damages.” The 35 countries that have ratified this convention are therefore bound to implement national legislation to enable a greater use of civil remedies by victims of corruption.<sup>1341</sup> As such, countries recognize the value of civil remedies and many nations already recognize the right of foreign states to sue in their civil courts.<sup>1342</sup>

Asset recovery through civil action avoids many of the problems encountered in efforts to criminally prosecute corrupt leaders in their home countries. Importantly, because it is a civil suit and there is no need to obtain a criminal conviction, the burden of proof is lower.<sup>1343</sup> This may greatly facilitate the recovery of assets from corrupt acts, though of course this does not result in a criminal conviction of the culprits. Nevertheless, although no criminal conviction will result, the civil proceeding facilitates the main theory being the importance of asset recovery, which is that by reclaiming the stolen money, the profit is taken out of corruption.<sup>1344</sup>

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<sup>1339</sup> See Civil Law Convention on Corruption, Nov. 4, 1999, Europe. T.S. No.174, <http://conventions.coe.int/treaty/en/Treaties/Html/174.htm>; Article 1 “Each Party shall provide in its internal law for effective remedies for persons who have suffered damage as a result of acts of corruption, to enable them to defend their rights and interests, including the possibility of obtaining compensation for damage.”

<sup>1340</sup> *Ibid.* See also Civil Law Convention on Corruption, Explanatory Report paragraph 26, <http://conventions.coe.int/Treaty/EN/Reports/Html/174.htm>.

<sup>1341</sup> The importance of the use of civil remedies in the fight against corruption was recognized at the EU level as early as 1997 with the Twenty Guiding Principles for the Fight against Corruption, a directive adopted by the Committee of Ministers of the Council of Europe, which called upon its member states to “ensure that civil law takes into account the need to fight corruption and in particular provides for effective remedies for those whose rights and interests are affected by corruption” (Council of Europe, 1997, Principle 17).

<sup>1342</sup> For examples of civil action asset recovery cases see generally Jean-Pierre Brun *Et. Al*, *supra* note 1197.

<sup>1343</sup> See John Hatchard, *Strengthening Presidential Accountability: Attorney General of Zambia v. Meer Care & Desai & Others*, 5(1) J. OF COMMONWEALTH L. & LEGAL EDU. 69 (2007).

<sup>1344</sup> *Ibid.*

Authorities that pursue civil actions to retrieve stolen assets have the option of initiating proceedings in domestic or foreign civil courts.<sup>1345</sup> The courts of the foreign jurisdiction may be competent if a defendant is a person (individual or business entity) living or incorporated in the jurisdiction (personal jurisdiction), if the assets are within or have transited the jurisdiction (subject matter jurisdiction), or if an act of corruption or money laundering was committed within the jurisdiction. As a private litigant, the authorities seeking redress can hire lawyers to explore the potential claims and remedies (ownership of misappropriated assets, tort, disgorgement of illicit profits, contractual breaches).<sup>1346</sup> The civil action will entail collecting evidence of misappropriation or of liabilities based on contractual or tort damages. Normally, it is possible to use evidence gathered in the course of a criminal proceeding in a civil litigation. It is also possible to seek evidence with the assistance of a court prior to filing an action.<sup>1347</sup>

In a private civil action, the plaintiff usually has the option to petition the court for a variety of orders, including the following:

- Freezing, embargo, sequestration, or restraining orders (potentially with worldwide effect) secure assets suspected to be the proceeds of crime, pending the resolution of a lawsuit-laying claim to those assets. In some jurisdictions, interim restraining orders may be issued pending the outcome of a lawsuit even before the lawsuit has been filed, without notice and with extraterritorial effect. These orders usually require the posting of a bond, guarantee, or other undertaking by the petitioner.
- Orders against defendants oblige them to provide information about the source of their assets and transactions involving them.

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<sup>1345</sup> UNCAC, *supra* note 1223, art. 53(a) (calling on states parties to permit another state party to initiate a civil action in domestic courts).

<sup>1346</sup> Jean – Pierre Brun, *Asset Recovery Handbook: A guide for Practitioners* 12 (2011) [hereinafter *Asset Recovery Handbook*].

<sup>1347</sup> *Ibid.*



- Orders against third parties for disclosure of relevant documents are useful in obtaining evidence from banks, financial advisers, or solicitors, among others.
- “No-say” (gag) orders prevent banks and other parties from informing the defendants of a restraint injunction or disclosure order.
- Generic protective or conservation orders preserve the status quo and prevent the deterioration of the petitioner’s assets, legal interests, or both. Such orders usually require showing the likelihood of success on the merits and an imminent risk in delaying a decision.<sup>1348</sup>

Thus, authorities may secure and recover assets and also seek damages based on torts, breach of contract or illicit enrichment or even proprietary claims. Under a torts claim,<sup>1349</sup> damages are issued in order to compensate a plaintiff for loss, injury, or harm directly caused by a breach of duty, including criminal wrongdoing, immoral conduct, or pre-contractual fault by the tortfeasor.<sup>1350</sup> In corruption cases, civil fraud, tortious interference, conspiracy, breach of trust, breach of fiduciary duty, or breach of agency duty (which gives rise to, claims for an accounting for the use and application of a principal's property), as well as abuse of power in office are all relevant causes of action.<sup>1351</sup> In breach of trust or fiduciary duty cases, equitable damages will often be available to remedy any impossibility to trace assets.

In certain cases of corruption there will be a contractual relationship between the harmed party and the perpetrator of the corrupt act. Remedies for invalidity or breach of contract will generally include monetary damages.<sup>1352</sup> The absolute invalidity of a contract made for an unlawful purpose is based on the social harm of corruption and the violation

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<sup>1348</sup> *Ibid.*

<sup>1349</sup> *See* Black Law Dictionary 1626 (9th ed. 2009). A tort is “[a] civil wrong, other than breach of contract, for which a remedy may be obtained, usu. in the form of damages; a breach of a duty that the law imposes on persons who stand in a particular relation to one another.”

<sup>1350</sup> *Ibid.*

<sup>1351</sup> Emile van der Does de Willebois & Jean-Pierre Brun, Using Civil Remedies in Corruption and Asset Recovery Cases, 45 Case W. Res. J. Int'l L. 615, 637 (2013).

<sup>1352</sup> *Ibid.* at 632.

of general moral principles rather than on the harm to the aggrieved party (the harm would be an argument for a voidable—as opposed to a void—contract).<sup>1353</sup> Article 34 of UNCAC provides that, “States Parties may consider corruption a relevant factor in legal proceedings to annul or rescind a contract.”<sup>1354</sup>

Unjust enrichment is a separate cause of action. The focus of this action is on “re-establishing equality as between two parties as a response to a disruption of equilibrium. Its *raison d'être* is founded in the injustice that lies in one person's retaining something which he or she ought not to retain, requiring that the scales be righted.”<sup>1355</sup> In these cases, there is no need to demonstrate that any loss was suffered.

Proprietary claims are expressly recognized in UNCAC.<sup>1356</sup> Owners of assets are to be entitled to exercise their full rights to those assets, regardless of who has possession of it. Although both civil and common law jurisdictions may handle these cases, common law jurisdictions, such as the U.S. and U.K., make a distinction between the person holding legal title of an asset and the person holding beneficial title to it.

As any means of legal justice, there are pros and cons to civil remedies, however, on balance it appears to be a means that should be utilized. The most obvious disadvantage would be the costs of tracing assets without the benefit of investigative tools found in criminal proceedings and the cost of the litigation itself.<sup>1357</sup> Cooperation and mutual assistance among states are also crucial to guarantee that efforts to locate the money will not be blocked or resisted by financial institutions. Furthermore, politics, both internal and international, always can hinder the willingness of parties to pursue a civil action.<sup>1358</sup>

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<sup>1353</sup> *Ibid.*

<sup>1354</sup> UNCAC, *supra* note 1223, art 34.

<sup>1355</sup> Martin S. Kenney, *The Fundamentals of a Civil Asset Recovery Action*, in *Asset Tracing & Recovery, The Fraudulent World Compendium* 111, 125 (2009).

<sup>1356</sup> *See* UNCAC, *supra* note 27, art. 53(a), (c) (stating that states are obliged to “recognize another State Party's claim as a legitimate owner of property [so] acquired”).

<sup>1357</sup> Webb, *supra* note 1226, at 210-11.

<sup>1358</sup> *Ibid.*

On the other hand, civil proceedings offer benefits that other asset recovery methods do not. Among these advantages are less-demanding requirements for linking the assets to the wrongdoing, the ability to claim damages generally, rather than claim particular assets, and a wider choice of parties to sue.<sup>1359</sup> Also, initiating a civil suit may prove to be easier by the range of venues. Establishing jurisdiction in a range of venues is easier (typically extending to countries where the stolen money has travelled), and as such, the case does not need to be brought in the home state of the official.<sup>1360</sup>

Civil actions tend to be helpful in addressing financial consequences of corruption, particularly in cases where numerous corrupt acts have been committed over a long period of time. In criminal cases, although some or all acts of corruption may be proven, it may be near impossible to trace all the proceeds because the trail is incomplete. In a situation where the direct link between the specific crime and the assets cannot be established, it is difficult to achieve further criminal action and confiscation in most jurisdictions.

In cases where the link between the assets and corruption is weak, civil suits may be able to overcome in a claim for general damages. Most of the time, large amounts of the proceeds from corruption are spent far from the country from which they were stolen. Proceeds may be laundered through various transactions, purchasing real estate, business investments, or buying luxury goods, making it difficult to locate the funds. In jurisdictions where only the asset directly related to the crime can be confiscated, items that were purchased with the stolen funds will not be criminally confiscated. The problem becomes more complicated in jurisdictions that recognize only property-based confiscation (an action to recover a particular asset) and less so where value-based confiscation is permitted (a legal action to recover the value of benefits that have been derived from criminal conduct and the imposition of a monetary penalty of an equivalent value). In any case, civil proceedings can provide a remedy to this issue by establishing a general claim for damages.

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<sup>1359</sup> Jean - Brunet Al, *supra* note 1197, at 5.

<sup>1360</sup> Hatchard, *supra* note 1343, at 73.

Another significant attribute of civil suits is that it expands the options of people to sue. Some jurisdictions do not extend to corporations or other entities in criminal proceedings, leaving only individuals. A plaintiff may seek to bring a civil action claiming damages from third parties with substantial financial assets, whose forfeitable criminal gains may be negligible, or whose criminal liability cannot be proved beyond a reasonable doubt but can be proved under a lesser standard.<sup>1361</sup> Civil suits also open the doors even if presidential immunity extends to civil suits under the laws of the kleptocrat's country, an action still may be brought against friends and family, who are often closely involved in corruption schemes. If a third party acted in concert with other wrongdoers, he may also be held liable for the greater damages caused by the others. Furthermore, civil actions may be brought even if a former president is deceased or has fled to another country.<sup>1362</sup>

## Conclusion

Corruption continues to be a universal issue and the act of stolen assets has yet to be fully addressed. Citizens from around the world have been damaged by these deeds and justice is to be sought. According to National Crime Agency (NCA)'s Annual report and account 2016-17 during the year the International Corruption Unit (ICU) has conducted 25 investigations into: the laundering of the proceeds of foreign grand corruption in the UK; instances of UK entities paying bribes overseas, and breaches of HM Treasury financial sanctions. As part of its ongoing enquires The ICU made eight arrests and has under restraint in connection with its investigations assets worth about £170M, Civil recovery of £900,000 from a suspected cyber criminal's estate, £735,538.25 confiscated from two defendants in a joint drug trafficking and money operation. Sentences of 12.5 years for two people who laundered the proceeds of a million-pound fraud. Both were also disqualified as a company director for 18 years. Use of European Arrest Warrant to enforce a

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<sup>1361</sup> Jean - Brunet Al, *supra* note 1197, at 6 (noting that third parties could include anyone who knowingly assisted the main actor, such as family members and associates, lawyers, banks, and bankers).

<sup>1362</sup> Kevin M. Stephenson, Larissa Gray, Ric Power, Jean-Pierre Brun, Gabriele Dunker, and Melissa Panjer, *Barriers to Asset Recovery: An Analysis of the Key Barriers and Recommendations for Action* (Washington, DC: World Bank, 2011), 71–74 (commenting that in the context of civil lawsuits officials or former officials and their assets may not enjoy the same kind of immunity as in the context of criminal prosecutions).

confiscation order for £4,929,334 with 6 months' time pay and 7.5 years default. A civil recovery and tax investigation resulted in the recovery of a property, valued at over £1 million, belonging to a Merseyside man believed to have been involved in drug trafficking, money laundering and tax evasion. The partner and fugitive drug-dealer son of a deceased Liverpool drug trafficker were deprived of almost £2million of property and assets following an NCA investigation.<sup>1363</sup>

Although many countries, such as the United States and United Kingdom, along with institutions such as the World Bank, are advancing their means to correct these wrong doings, more is still to be done. Criminal proceedings and non-conviction based forfeiture are great tools in this realm of criminal activity, but states should also look to civil suits as a means for obtaining justice. Civil remedies, although not without its faults, can provide an array of benefits. Furthermore, it is also expressly advocated for in UNCAC. This tool has already been used to punish corrupt individuals and return stolen assets. Further study and practice of civil actions should hopefully continue to grow as asset recovery is pursued.

The approaches elaborated at the international and national levels for assets recovery aim to tackle this problem by engaging international financial institutions. Therefore, the next chapter will examine the International Financial Institutions (IFIs) and its' role in combating financial crimes.

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<sup>1363</sup> National Crime Agency Annual Report and Accounts 2016-17

## CHAPTER 8

### International Financial Institutions and its Sanctions Regime

#### Introduction

How International Financial Institutions Combat Financial Crimes?

As the world progressively becomes more globalized, financial crimes must be addressed on a global scale, however, questions remain as to how the international community should achieve such an objective.<sup>1364</sup> An effective response must be three dimensional. First, the root causes of the problem must be addressed. Second, the response must provide a regulatory framework to prevent future infractions. Lastly, it must ensure compliance through an effective enforcement mechanism. The following section will examine the role for the World Bank and the International Monetary Fund (“IMF”), first through a brief overview of the international financial institutions respective fields of operation and the extent to which these institutions' policies and lending facilities have evolved over time; and second, through an analysis of their potential to combat financial crimes.

In July 1944, delegates from forty-four allied nations<sup>1365</sup> assembled at the Mount Washington Hotel in Bretton Woods, New Hampshire, with the goal of creating institutions that, through a unified system of purpose, policies, and rules, would regulate the international monetary system while concurrently restructuring the international relations which had begun to foster before World War II.<sup>1366</sup> While each of the forty-four nations

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<sup>1364</sup> Jennifer Trahan, *Terrorism Conventions: Existing Gaps and Different Approaches*, 8 *New Eng. Int'l & Comp. L. Ann.* 215, 220-21 (2002).

<sup>1365</sup> The Department of State, *Proceedings and Documents of United Nations Monetary and Financial Conference Vol. I at 5* (1948) [hereinafter *Bretton Woods Conference Vol. I*]. The forty-four nations: Australia, Belgium, Bolivia, Brazil, Canada, Chile, China, Colombia, Costa Rica, Cuba, Czechoslovakia, Dominican Republic, Ecuador, Egypt, El Salvador, Ethiopia, France, Greece, Guatemala, Haiti, Honduras, Iceland, India, Iran, Iraq, Liberia, Luxembourg, Mexico, Netherlands, New Zealand, Nicaragua, Norway, Panama, Paraguay, Peru, Philippine Commonwealth, Poland, Union of South Africa, Union of Soviet Socialist Republics, United Kingdom, United States of America, Uruguay, Venezuela, and Yugoslavia.

<sup>1366</sup> See *Ibid.* at 5-7; Dept. of Public Info, *Everyone's United Nations* 365 (9th ed. 1979) (relaying that there were four versions of the draft documents that were presented to the delegates: The U.S. version, the U.K. version, new material, and material taken from the Monetary Fund proposal). Edward S. Mason & Robert E. Asher, *The World Bank Since Bretton Woods* 21 (1973) (discussing that lesser developed nations, including European countries which suffered during World War II, held a greater interest in development

was present, the Bretton Woods agreement was negotiated primarily between Britain and the United States.<sup>1367</sup> The conference resulted in the formation of the International Bank for Reconstruction and Development (“World Bank”) and the International Monetary Fund (“IMF”).<sup>1368</sup>

### **The World Bank and its Mandate**

Although many perceive the World Bank as a single unit, it is actually composed of four financial institutions that are interrelated under the title of World Bank Group.<sup>1369</sup> The World Bank is a multidimensional institution that enables its member states to

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of the IBRD than the IMF). Well established monetary conditions are the cornerstone to successful lending and a precondition to the membership in the Bretton Wood Institutions. Id.

<sup>1367</sup> G. John Ikenberry, *The Political Origins of Bretton Woods, A Perspective on the Bretton Woods System* 155 (1993) (noting that the United States and Britain were the two major Western powers from World War II); see also Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods To The 1990s* 33 (1996) (“The Bretton Woods negotiations are often portrayed as a battle of wills between Keynes and White.”); M.J. Stephey, *A Brief History of Bretton Woods System*, *TIME* (Oct. 21, 2008), available at <http://www.time.com/time/business/article/0,8599,1852254,00.html>.

<sup>1368</sup> Lee E. Preston & Duane Windsor, *The Rules of the Game in the Global Economy: Policy Regimes for International Business* 132-33 (2d. ed. 1997) (explaining that the names of the institutions can be confusing given the IMF was established to carry out exchange, reserve, and short-term loan functions normally associated with “bank,” while the IBRD is essentially a “Fund” for providing long-term loans). The IBRD was established on December 27, 1945 with the purpose to: “[A]ssist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes; to promote private foreign investment and, when private investment is not readily available on reasonable terms, to supplement it by providing loans for productive purposes out of its own capital funds; and to promote the balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment for the development of the productive sources of the Bank's members.” Dept. of Public Info., *Everyone's United Nations* 364-65 (9th ed. 1979). Membership to the IBRD is open to all members of the IMF. Id. at 364. The IMF was established with the intent of facilitating international monetary cooperation; promoting exchange rate stability; assisting in the establishment of multilateral payment systems; eliminating foreign exchange restrictions; providing loans to nations experiencing balance of payments issues; all for the purpose of creating conditions for strong economic growth. Id. at 55.

<sup>1369</sup> *The World Bank: Structure and Polices* 12 (Christopher L. Gilbert & David Vines eds., 2000) [hereinafter *World Bank: Structure and Polices*]. The International Bank for Reconstruction and Development (“IBRD”) is the original and central institution in the World Bank Group. Id. Its primary purpose of IRBD is “to borrow funds and lend these on to qualifying member governments or to public sector institutions for agreed projects.” Id. The second institution of the World Bank is the International Development Agency (“IDA”), whose role is that of an aid agency, concentrating its activities to sixty “IDA countries” that have a low GDP per capita. Id. Even though the IBRD and the IDA are nearly completely coextensive, their differences essentially lie on the duration of the loan, its interest rates and the source of the loaned funds. Id. at 12-13. In essence, “[t]he Bank, as IDA, provides both development assistance and development aid while, as the IBRD, it provides assistance and enhanced access to capital.” Id. at 13. The third unit of the World Bank is the International Finance Corporation (“IFC”), which was founded in 1956. Id. at 12. This institution's main focus is to strengthen domestic industries by lending to private sector institutions and taking equity shares in private sector enterprises. Id. The fourth and last unit is the Multinational Investment Guarantee Agency (“MIGA”), which was created in 1988. Id. Its purpose is to guarantee “private sector investors against expropriation and repatriation risks in developing countries.”

contribute in the collective “promotion, worldwide of economic sustainable development and poverty reduction.”<sup>1370</sup> The Bank’s aims are pursued through lending, producing research, providing economic analysis and the establishment of policy advice and technical assistance.<sup>1371</sup> As a creation that emerged from World War II, the World Bank was originally intended to handle the financial necessities of the post-war reconstruction.<sup>1372</sup> Thus, reconstruction was the World Bank’s primary focus during the first decade or so of its initiation.<sup>1373</sup> However, by the 1960s, the world’s politics had changed dramatically.<sup>1374</sup> In order to adapt to these changes, the World Bank needed to alter its priorities “from reconstruction to development and from Europe to the developing world.”<sup>1375</sup>

Despite the fact the World Bank’s membership is dependent on members of the IMF, the objectives of the two institutions are very different, and this is clear from the World Bank’s functions being primarily a financial intermediary.<sup>1376</sup> Funds are raised through selling bonds on the international capital market and then are subsequently lent to member states a small mark-up over the World Bank’s AAA<sup>1377</sup> borrowing rate.<sup>1378</sup> The Bank lends either “directly to a member government or [requires that its loans be]

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<sup>1370</sup> Ibid.

<sup>1371</sup> Ibid.

<sup>1372</sup> Ibid. (quoting Harry Dexter, U.S. Treasury official and one of the drafters for the World bank who stated that the primary objectives of the Bank were to “provide or otherwise stimulate long-term, low-interest-rate loans for reconstruction and for the development of capital-poor areas.”).

<sup>1373</sup> Ibid.

<sup>1374</sup> Ibid.

<sup>1375</sup> Ibid.

<sup>1376</sup> Rajesh Swaminathan, *Regulating Development: Structural Adjustment and the Case for National Enforcement of Economic and Social Rights*, 37 *COLUM. J. TRANSNAT’L L.* 161, 164 (1998) (commenting that the Bank’s Articles of Agreement states that its membership is limited to sovereign states who are already members of the IMF). The two institutions are similar in organizational and voting structures. The Board of Governors, representing all member states, has all of the World Bank’s powers vested in it, while the Executive Directors conduct the institution’s daily operations. See *Articles of Agreement of the International Bank for Reconstruction and Development*, opened for signature Dec. 27, 1945, art. V, sec. 2, 60 Stat. 1440, as amended Dec. 16, 1965, 16 U.S.T. 1942, 2 U.N.T.S. 134 [hereinafter *World Bank Articles of Agreement*]. The Bank and the IMF both have a total of 24 Executive Directors with the United States, Japan, Germany, France, United Kingdom, China, Russia, and Saudi Arabia, having their own seats on the Board, and the remaining directors elected on a rotating two-year basis. See *World Bank, IBRD/IFC/IDA Executive Directors and Alternates*.

<sup>1377</sup> John Burgess, *Groups Plan Boycott of World Bank Bonds*, *Washington Post*, Apr. 11, 2000, <http://www.globalpolicy.org/soecon/bwi-wto/wbank/bonds.htm>; see also *The World Bank’s Bonds Are Getting Looser*, <http://www.wbbeurope.org/tool-kit-article3.php> (explaining that an AAA rating indicates a guarantee that anyone who purchases AAA-rated bonds will be sure to get their money back, with the agreed interest, when the bonds mature).

<sup>1378</sup> Swaminathan, *supra* note 1376, at 168.



guaranteed by the member government in whose territory the project [or program] is located.”<sup>1379</sup> Additionally, the World Bank limits the use of such loans “for the foreign exchange component of specific [programs or] projects.”<sup>1380</sup> The World Bank places conditions on the borrowing state adopting certain policies in order to receive disbursements. Article III(4) of the World Bank’s Articles of Agreement provides that the World Bank may offer loans “to any member or any political subdivision thereof and any business, industrial, and agricultural enterprise in the territories of a member,” subject to the condition that the member state fully guarantee the repayment of the principal and interest.<sup>1381</sup> The Bank is also required to “pay due regard to the prospect that the borrower... will be in [the] position to meet its obligations under the loan...”<sup>1382</sup> Conditions that are to be met by borrowing states are comprehensive and typically include policy and structural reforms, including improved governance, the elimination of corruption and gender equality, along with other obligations.<sup>1383</sup>

### **The International Monetary Fund and its Mandate**

The IMF was founded as a special agency on the United Nations to promote the stability of the international monetary system.<sup>1384</sup> The IMF’s job is to focus on preventing economic crises from occurring by advising member states on the soundness of their economic policies and to provide short-term financing for those members experiencing balance of payment issues.<sup>1385</sup>

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<sup>1379</sup> Kim Reisman, *The World Bank and the IMF: At the Forefront of World Transformation*, 60 *Fordham L. Rev.* S349, 353 (1992).

<sup>1380</sup> *Ibid.*

<sup>1381</sup> World Bank Article of Agreement, *supra* note 1376, art. III, sec. 4.

<sup>1382</sup> *Ibid.*

<sup>1383</sup> Herbert V. Morais, *The Globalization of Human Rights Law and The Role of International Financial Institutions in Promoting Human Rights*, 33 *GEO. WASH. INT’L L. REV.* 71, 94-95 (2000).

<sup>1384</sup> See generally International Monetary Fund; What is the International Monetary Fund, <http://www.imf.org/external/pubs/ft/exrp/what.htm> [hereinafter *What is the IMF?*].

<sup>1385</sup> See *ibid.* The IMF reports to the ministries of finance and the central banks of governments of its member states. A Board of Governors, representing each member state, is the highest power within the institution and meets once a year to decide on significant policy issues. The Executive Board which meets several times per week at the IMF’s headquarters in Washington, D.C. takes care of day-to-day requirements. The Executive Board consists of a total of 24 Executive Directors with the United States, Japan, Germany, France, United Kingdom, China, Russia, and Saudi Arabia, having their own seats on the Board, and the remaining directors elected on a rotating two-year basis. Decisions are made determined on a weighted voting system with the state with the larger “quota” having more votes. These quotas are basically capital subscriptions that members pay upon joining the institution and are meant to reflect each

The IMF's Articles of Agreement embodies its statutory purpose.<sup>1386</sup> Its objectives include the advancement of balanced world trade expansion, exchange rate stability, the establishment of a multilateral system of payments, and temporary financial assistance to member states experiencing balance of payment problems.<sup>1387</sup> To promote its objectives, the IMF inspects the performance of each member's economy as a whole, concentrating mainly on its macroeconomic policies — policies on exchange rates, the management of money, and a member state's government budget — and financial sector policies.<sup>1388</sup> The IMF additionally considers a member state's structural policies, such as labour market policies, that may affect macroeconomic performance.<sup>1389</sup> Moreover, the institution counsels its members on the best course of action in re-evaluating national policies so they more effectively pursue objectives such as high employment, low inflation, and sustainable economic growth.<sup>1390</sup> This technical assistance is further supplemented with training programs for government and central bank officials of member states.<sup>1391</sup>

The IMF's ability to disburse loans is a critical aspect of its mandate. Sustaining a healthy balance is a vital prerequisite to the IMF's founding purpose of supporting global economic stability.<sup>1392</sup> Article I of the IMF's Article of Agreements states that this is required to make funds “temporary available under adequate safeguards...to correct maladjustments in their balance-of-payments without resorting to measures destructive national or international prosperity.”<sup>1393</sup>

In order to participate in the IMF's lending, member states must comply with the condition of adopting policies designed to correct balance of payment problems.<sup>1394</sup> Article V(3)(a) of the IMF's Articles of Agreement provides that the IMF “shall adopt policies on

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member's relative size in the global economy. The major developed countries benefit from greater voting powers because quotas are based on the economic size of a country.

<sup>1386</sup> Articles of Agreement of the International Monetary Fund, opened for signature Dec. 27, 1945, 160 Stat. 1401, as amended April 1, 1978, 29 U.S.T. 2203, 2 U.N.T.S. 39, available at <http://www.imf.org/external/pubs/ft/aa/index.htm> [hereinafter IMF Articles of Agreement].

<sup>1387</sup> *Ibid.*

<sup>1388</sup> What is the IMF?, supra note 1384; IMF Articles of Agreement, supra note 1386, art. I, para. V.

<sup>1389</sup> What is the IMF?, supra note 1384.

<sup>1390</sup> *Ibid.*

<sup>1391</sup> *Ibid.*

<sup>1392</sup> IMF Articles of Agreement, supra note 1386, art. I, para. v.

<sup>1393</sup> *Ibid.*

<sup>1394</sup> What is the IMF?, supra note 1384.

the use of its general resources... and may adopt special policies for special balance of payments problems, that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund.”<sup>1395</sup> By requiring performance-based conditions, the IMF is able to “independently... examine [the] country's need for balance of payments assistance and to require the adoption of corrective policies before funds are disbursed.”<sup>1396</sup> Conditions may be required include trade liberalization measures, depreciation of the exchange rate, decreasing the fiscal deficit, and restrictions on the credit provided by domestic banks.<sup>1397</sup> According to the IMF, the “conditionality associated with IMF lending helps to ensure that by borrowing from the IMF, a country does not just postpone hard choices and accumulate more debt, but is able to strengthen its economy and repay the loan.”<sup>1398</sup>

### **The Power of the World Bank and IMF to Fight Financial Crimes**

The World Bank and the IMF are international institutions with unparalleled resources at their disposal, putting them in an exceptional position to combat financial crimes.<sup>1399</sup> These international financial institutions (IFIs) have several means available to them in order to the crimes discussed at the beginning of this chapter. Although there are many critics of the IFIs,<sup>1400</sup> collectively, they are the most capable to address financial crime issues. Additionally, in accordance with the increasing recognition of the importance of financial integrity issues, the roles of the World Bank and IMF have evolved their duties over the years in order to take up this challenge.<sup>1401</sup>

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<sup>1395</sup> IMF Articles of Agreement, *supra* note 60, art. V sec. 3(a).

<sup>1396</sup> Swaminathan, *supra* note 1376, at 166.

<sup>1397</sup> Mary C. Tsai, Globalization and Conditionality: Two Sides of the Sovereignty Coin, 31 *LAW & POL'Y INT'L BUS.* 1317, 1321 (2000).

<sup>1398</sup> What is the IMF?, *supra* note 1384.

<sup>1399</sup> Olivera Medenica, The World Bank, the IMF and the Global Prevention of Terrorism: A Role for Conditionality, 29 *BROOK. J. INT'L L.* 663, 692 (2004)

<sup>1400</sup> *Ibid.*

<sup>1401</sup> The IMF and the Fight Against Money Laundering and the Financing of Terrorism, Fact Sheet, Mar. 31, 2013, <http://www.imf.md/imf-aml.html> (discussing how the involvement of the IMF has evolved in the field of anti-money laundering and terrorist financing).

The IFIs together have an array of tools available to them to combat financial crimes.<sup>1402</sup> The IFIs currently utilize many of the mechanisms at their disposal primarily to prevent money laundering and terrorist financing, which has become a key aspect of the IFIs' duties.<sup>1403</sup> Some of the tools that should be utilized more in preventing financial crimes will be discussed below. These include conditions used to provide loans, technical assistance and the assessments.

### **The Role of Conditions as a Tool for Financial Crimes**

One of the main and controversial aspects of the IFIs is the use of conditions for the disbursement of aid, which are semi-contractual in nature.<sup>1404</sup> As is common with many lending facilities, the IFIs require states requesting aid to provide reliable commitments to ensure the repayment and cooperation in the application of the loans.<sup>1405</sup> Conditions imposed by the IFIs are generally applied as policy measures endorsed by the IMF and the World Bank.<sup>1406</sup> These conditions, which aim to help the state to stabilize and grow, and are often criticized for this inclusion of policy-oriented objectives. Nevertheless, they are an essential component of the IFIs.<sup>1407</sup>

During the 1980s, policy conditions incorporated wide-ranging macro-economic stabilization and structural economic reform.<sup>1408</sup> However, during the early 1990s, there began a fundamental shift in policies applied by the IFIs with the application of the concept of “good governance” as an objective and also a condition for loan disbursement.<sup>1409</sup> The

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<sup>1402</sup> Wesley J.L. Anderson, *Disrupting Threat Finances Utilization of Financial Information to Disrupting Terrorist Organizations in the Twenty First Century*. P. 123(2010).

<sup>1403</sup> Finance & Development (Int'l Monetary Fund, External Relations Dep't, 2000) (explaining that financial crimes such as corruption, tax crimes, insider dealing and fraud are all predicate crimes to money laundering)

<sup>1404</sup> Tony Killick Et Al., *Aid and Political Economy of policy change* 6 (1998) (defining conditions as a mutual arrangement by which a government takes, or promises to take, certain policy actions, in support of which an IFI...or other agency will provide specified amounts of financial assistance).

<sup>1405</sup> Michael Chossudovsky. *The Globalization of Poverty: Impacts of the IMF and the World Bank Reforms*. p. 45 (1997)

<sup>1406</sup> *Ibid.*

<sup>1407</sup> Medenica, *supra* note 1399, at 687.

<sup>1408</sup> See *Id.* at 688-89 (listing policy programs which included reforms such as currency devaluation, liberalization of the labor market, reducing budget deficits, price and trade liberalization, among others).

<sup>1409</sup> The World Bank defines “governance” as “the form of political regime; the process by which authority is exercised in the management of a country's economic and social resources for development; and the capacity of governments to design, formulate and implement policies and discharge functions.” The IMF defines it as “all aspects of the way a country, corporation, or other entity is governed” and “includes the

transition in policy was due to the IFIs recognition “that the reasons for underdevelopment and mismanaged government are ‘sometimes attributable to weak institutions, lack of an adequate legal framework, damaging discretionary interventions, uncertain and variable policy frameworks and a closed decision-making process which increases risks of corruption and waste.’”<sup>1410</sup> The shift also reflected the pressure resulting from donor countries requesting that the IFIs tackle issues of corruption, economic irresponsibility and bureaucratic failures, which prevented the repayment of financial assistance.<sup>1411</sup> As a means of utilizing conditions as a tool to combat financial crimes, the IFIs could incorporate international law into their financial assistance programs. This could take the form as requiring states in need of assistance to implement international treaties that address financial crimes into state legislation.<sup>1412</sup> For instance, currently, IFIs play a key role in monitoring the implementation of the Financial Action Task Force (“FATF”)<sup>1413</sup> policies for anti-money laundering and combating the financing of terrorism (“AML/CFT”).<sup>1414</sup> The IFIs participation in this role mainly involves assessments and technical assistance (to be discussed below). However, conditions could also be applied to address the issues of AML/CFT along with the other financial crimes that plague the economic conditions of the global market. Conditions could focus on the areas of prevention, suppression and the exchange of information in order to succeed in the fight against financial crimes. In this manner, each disbursement of funds would be contingent on the actual implementation of law in order to combat financial crimes in general. Such conditions, although not directly within the mandates of the IFIs are connected to them by maintaining economic stability and aiding states in development.

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economic policy interactions that fall within the mandate and expertise of the IMF,” as well as “their effectiveness; their transparency, and thus the accountability of policy makers; and the extent to which they meet internationally accepted standards and good practices.” See Carlos Santiso, World Bank and Good Governance: Good Governance and Aid Effectiveness: The World Bank and Conditionality, 7 *Geo. Pub. Policy Rev Geo.* 1, 2, 4 (2001).

<sup>1410</sup>See *Ibid.* at 5.

<sup>1411</sup> *Ibid.*

<sup>1412</sup> See Medenica, *supra* note 1399, at 704 (discussing the possibilities of the IFIs requiring the implementation of United Resolution 1373 as a means to prevent terrorism).

<sup>1413</sup>See Kenneth S. Blazejewski, The FATF and Its Institutional Partners: Improving the Effectiveness and Accountability of Trans governmental Networks, 22 *TEMP. INT'L & COMP. L.J.* 1, 30 (2008) (“The FATF is The international trans-governmental network charged with designing and effective regime of anti-money laundering and combating the financing of terrorism policies”).

<sup>1414</sup> *Ibid.*

## **Expanding the IFIs current Technical Assistance and Assessment Measures to Address Financial Crimes**

Currently, the IFIs rely on technical assistance and assessments in order to monitor the implementation of FATF Recommendations among their member states.<sup>1415</sup> This is done to through surveillance of economic conditions through the Financial Sector Assessment Program (“FSAP”).<sup>1416</sup> The FSAP assesses the reliability of member states’ financial systems through detecting risks and vulnerabilities, evaluating financial need, and assisting members in addressing these weaknesses through technical assistance and policy recommendations.<sup>1417</sup> In order to aid this aim, the Report on the Observance of Standards and Codes (“ROSC”) was created. ROSC exists to report on the implementation of twelve standards that the IMF has recognized as “benchmarks of good practices” in regard to financial and economic soundness of a state.<sup>1418</sup> However, participation in FSAP is voluntary for the members of the IFIs.<sup>1419</sup>

Assessments conducted by the IFIs through the FSAP program are a critical means to combat AML/CFT crimes, which is also necessary to prevent other financial crimes. However, the voluntary nature of this program obviously can leave some countries unchecked. Hence, the FSAP should be required for members in order for the IFIs to apply FATF Recommendations as well as monitor all member prevention mechanisms. As of 2013, only seventy assessments of country compliance of FATF Recommendations had

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<sup>1415</sup> FATF, Financial Action Task Force 40 Recommendations (2003), available at [http://www.fatf-gafi.org/document/28/0,3343,en\\_32250379\\_32236930\\_33658140\\_1\\_1\\_1\\_1,00.html#r21](http://www.fatf-gafi.org/document/28/0,3343,en_32250379_32236930_33658140_1_1_1_1,00.html#r21). See Blazejewski, supra note 1413, at 30.

<sup>1416</sup> Int’l Monetary Fund, Public Information Notice, IMF Executive Board Reviews Experience with the Financial Sector Assessment Program, <http://www.imf.org/external/np/sec/pn/2005/pn0547.htm> [hereinafter IMF FSAP Board Review].

<sup>1417</sup> Ibid.

<sup>1418</sup> Int’l Monetary Fund, Standards and Codes: The Role of the IMF, <http://www.imf.org/external/np/exr/facts/sc.htm>. The twelve standards include accounting, auditing, banking supervision, corporate governance, data dissemination, fiscal transparency, insolvency and creditor rights, insurance supervision, monetary and financial policy transparency, payments systems, securities regulation, and money laundering and the financing of terrorism.

<sup>1419</sup> IMF FSAP Board Review, supra note 1416.

been conducted.<sup>1420</sup> This number is less than half of the member states of the IFIs,<sup>1421</sup> indicating a gap in the IFIs ability to fight financial crimes.

The technical assistance program of the IFIs is another tool that can be expanded upon in order to increase the success of financial crime prevention. Technical assistance is one tool that can be considered the most significant in order to achieve policy reform to combat financial crime.<sup>1422</sup> The aim of the technical assistance is to improve governance by tackling the underlying systematic problems in member countries.<sup>1423</sup> Typical activities include advice on particular macroeconomic policy issues, technical advice on practices and institution-building in the IMF's core areas of responsibility—mainly central banking, monetary and exchange rate policies, public finances and budgeting, tax policy and administration, and statistics—the promotion of international standards and codes of good policymaking, and training provided to government and central bank officials to strengthen skills in the institutions responsible for policy-making, such as finance ministries and central banks.<sup>1424</sup> Technical assistance is also used as a means to help countries meet internationally recognized standards in various areas related to economic policymaking.<sup>1425</sup>

Technical assistance receives a great deal of criticism for being “supply-driven,” meaning that its activities are driven by donors rather than being provided to aid the recipient country’s needs.<sup>1426</sup> Nevertheless, the IFIs’ policies are meant to be implemented as a means to protect the country itself and for the greater good of the world economy.

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<sup>1420</sup> U.S. Dep't of Treasury, Implementation of Legislative Provisions Relating to the International Monetary Fund: A Report to Congress 19 (2013), available at [http://www.treasury.gov/resource-center/international/int-monetary-fund/Documents/2013-12-13\\_%28Legislative\\_Mandate\\_Report%29.pdf](http://www.treasury.gov/resource-center/international/int-monetary-fund/Documents/2013-12-13_%28Legislative_Mandate_Report%29.pdf).

<sup>1421</sup> There are a total of 188 member states in the IMF and World Bank, as membership in the World Bank is dependent on membership in the IMF. See Member Countries, World Bank, <https://www.worldbank.org/en/about/leadership/members>.

<sup>1422</sup> Lending & Technical Assistance, World Bank, <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPUBLICSECTORANDGOVERNANCE/0,,contentMDK:20223795~menuPK:468641~pagePK:210058~piPK:210062~theSitePK:286305,00.html>

<sup>1423</sup> Ibid.

<sup>1424</sup> IMF Technical Assistance: Transferring Knowledge and Best Practice (May 2003), <https://www.imf.org/external/pubs/ft/exrp/techass/techass.htm#whatis>.

<sup>1425</sup> Ibid.

<sup>1426</sup> Williams, G., Jones, S., Imber, V., and Cox, A., A Vision for the Future of Technical Assistance in the International Development System', Oxford Pol'y Manage. (2003), [http://www.opml.co.uk/policy\\_areas/aid\\_policy/ed768\\_vision\\_ta.html](http://www.opml.co.uk/policy_areas/aid_policy/ed768_vision_ta.html)

Poorly structured economic policies and goals can let financial crimes go undetected. IFIs have a great deal of expertise in financial crimes and the personnel who assist in technical assistance are trained for these matters to be addressed. Nevertheless, it is important for countries to take ownership and understand the process and what is actually being done and also what is needs to be done in order for there to harmonious cooperation between recipients and the IFIs.<sup>1427</sup> Extra time should be taken in order to ensure capacity building is accomplished, not just that the “job gets done.”<sup>1428</sup>

Donor objectives should be considered important but not a priority.<sup>1429</sup> The IFIs are the ones who understand the importance of sound policy in order to fight financial crimes, and as seen above, these crimes are complex and difficult to fight. Cooperation and capacity building is what is essential to focus on during technical assistance.<sup>1430</sup> Only by providing the tools and knowledge necessary to recipient countries to combat these crimes will any real progress be made.<sup>1431</sup> This can be improved by creating capacity building plans based on policy objectives and national development strategies.<sup>1432</sup> Also, the full use of national resources should be addressed in order to have all parts and agencies involved in the assistance project.<sup>1433</sup>

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<sup>1427</sup> Ibid.

<sup>1428</sup> ActionAid, *Real Aid: Making technical assistance work*, (2006), [http://www.actionaid.org.uk/doc\\_lib/real\\_aid2.pdf](http://www.actionaid.org.uk/doc_lib/real_aid2.pdf).

<sup>1429</sup> Ibid.

<sup>1430</sup> Ibid.

<sup>1431</sup> Ibid.

<sup>1432</sup> Ibid.

<sup>1433</sup> Ibid.



## Sanctions Regime

Corruption can undermine development efforts across the world. Although international financial institutions implement a range of criteria and mechanisms in order to secure money transfer from falling into corrupt hands, it is still being difficult to combat corruptions. It has been reported that billions of dollars have been used for corrupt purposes when that money was given for development projects. This continuous corruption has lead international financial institutions to begin to harmonize their strategies as a means of posing a united front against corruption since many recipient governments are not able or trusted to maintain the funds for the designated projects.

The principal multilateral development banks (MDBs)<sup>1434</sup> have begun to strategize and build international cooperation to address corruption, through sanctions and debarment regimes. In addition to establishing uniform, principle-based standards for investigations among international financial institutions, common definitions of sanctionable practices, and a common system of mutual enforcement of debarment or “cross-debarment,” the MDBs continue to work to further integrate and coordinate their respective systems.<sup>1435</sup> Greater harmonization among the MDBs provides several benefits for all stakeholders, and particularly helps to enforce the rule of law and fight corruption. The World Bank is the most active MDB from an enforcement perspective. Since 2007 through 2014, the World Bank has debarred or sanctioned a total of around 250 entities and individuals.<sup>1436</sup> The majority, about 60%, of these sanctions decisions were handed down during 2012 – 2013, demonstrating a clear trend towards increased levels of enforcement.<sup>1437</sup> However, a key issue to the MDBs’ sanction regime is the lack of effort to strengthen law enforcement and

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<sup>1434</sup> The multilateral development banks (MDBs) include the African Development Bank Group (consisting of the African Development Bank, the African Development Fund, and the Nigeria Trust Fund), the Asian Development Bank, the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank Group (consisting of the Inter-American Development Bank, the Inter-American Investment Corporation, and the Multilateral Investment Fund), and the World Bank Group (WBG) (consisting of the International Bank for Research and Development (IBRD), the International Development Association (IDA), the International Finance Corporation, and the Multilateral Investment Guarantee Agency).

<sup>1435</sup> Frank A. Fariello, Jr. & Conrad C. Daly, *Coordinating the Fight Against Corruption among MDBs: The Past, Present and Future of Sanctions*, 45 *GEO. WASH. INT’L L. REV.* 253, 254 (2013).

<sup>1436</sup> See Office of Suspension and Debarment, *The World Bank Office of Suspension and Debarment: Report on Functions, Data and Lessons Learned 2007–2013*, World Bank (2014).

<sup>1437</sup> *Ibid.*

government at the national level. Sanctions are targeted to private suppliers, while governments are not held accountable when fraud and corruption occur.

Thus, this chapter proposes that the MDBs sanction system should continue to harmonize their efforts, while also demanding integrity measures that aid in strengthening domestic efforts to combat corruptions. Section II will briefly discuss the overall corruption regime and its development. It will then discuss more specifically the World Bank and how it began its role in anticorruption. Section III will then discuss the sanctions regime of the MDBs and how they have harmonized their efforts, with a focus primarily on the World Bank given its central role in combating corruption and because many of the other international financial institutions have based their system on that of the World Bank's. Section IV will discuss the issues found within the sanctions regime and conclude with recommendations.

### **History of the Anticorruption Regime**

Anticorruption efforts have been ongoing for many years now. As there has been increased awareness over the impact of corruption, more attention and measures are being put in place in order to combat it. Recently, anticorruption efforts have been focused on terrorist financing;<sup>1438</sup> drug trafficking; and the obstacles to economic aid and development funds caused by corrupt practices. The United States was a major player on the anticorruption movement, most notably in 1977, when the US Congress took the lead and incorporated the Foreign Corrupt Practices Act ("FCPA").<sup>1439</sup> The FCPA was the first law of its kind, prohibiting transnational bribery, although it is limited to corrupt transactions in business operations, it does not extend outside of the commercial circle.

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<sup>1438</sup> See, e.g., UNCAC Preamble para 2: "Concerned also about the links between corruption and other forms of crime, in particular organized crime and economic crime, including money-laundering."

<sup>1439</sup> Foreign Corrupt Practices Act of 1977, 15 USC § 78dd-1 (1977) ("FCPA')

As corporations in the US began to feel the seriousness of the anticorruption regime emerging, the US began to lobby for international measures and an anticorruption treaty in order to have greater reach.<sup>1440</sup> The United Nations Economic and Social Council (“ECOSOC”) began its focus on the offering of bribes by transnational corporations from developing countries, instead of focusing on public officials demand for bribes. However, tensions were great between developed and developing nations and discussions soon broke down. The US soon turned to the OECD, which eventually adopted the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (“OECD Convention”).<sup>1441</sup> As anticorruption efforts began to be raised on an international level, the World Bank slowly began to enter into the realm of combating it. Scandals began to occur with funds which fuelled a new awareness.<sup>1442</sup> The World Bank sanctions regime was significantly influenced by the US Foreign Corrupt Practices Act of 1998, as well as the nature of the procurement approach found in the US Federal Acquisition Regulation, especially subpart 9.4.<sup>1443</sup> Though the two systems have their differences, particularly with regard to the World Bank’s limited sanctionable practices, they are similar in many respects.<sup>1444</sup> Nevertheless, the World Bank also began take on a role of its own in the fight against corruption.

### **The World Bank and its entry into anticorruption**

Although today the World Bank can be seen as a forerunner in the fight against corruption, there were many years of hesitation to address the matter.<sup>1445</sup> The issue of

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<sup>1440</sup> Jan Wouters et. al., *The International Legal Framework Against Corruption: Achievements and Challenges*, 14 MELB. J. INT’L L. 205, 209 (2013)

<sup>1441</sup> Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, opened for signature 17 December 1997, [1999] ATS 21 (entered into force 15 February 1999) (‘OECD Convention’).

<sup>1442</sup> See, e.g., Richard Calkins et al; *Dealing with Governance and Corruption Risks in Project Lending: Emerging Good Practices* (Note, World Bank, February 2009) <[http://siteresources.worldbank.org/EXTGOVANTICORR/Resources/3035863281627136986/EmergingGoodPracticesNote\\_8.11.09.pdf](http://siteresources.worldbank.org/EXTGOVANTICORR/Resources/3035863281627136986/EmergingGoodPracticesNote_8.11.09.pdf)>.

<sup>1443</sup> Pascal Hélène Dubois, *Domestic and International Administrative Tools to Combat Fraud & Corruption: A Comparison of US Suspension and Debarment with the World Bank’s Sanctions System*, U. CHI. LEGAL F. 195, 196-97 (2012).

<sup>1444</sup> *Ibid.* at 234-35.

<sup>1445</sup> Anne- Marie Leroy & Frank Fariello, *World Bank, The World Bank Group Sanctions Process and its Recent Reforms* 9 (2012)

“leakage” of proceeds was always an issue to prevent which the Bank managed through fiduciary systems by establishing procedures such as procurement rules, financial reporting and audits, and controls on disbursement.<sup>1446</sup> The issue in addressing corruption was that it was widely believed that matters of governance were considered political issues and did not fall under the Bank’s mandate of economic development.<sup>1447</sup> Moreover, for the Bank to enter into issues of governance was perceived as contradictory of the “political prohibition” set forth in the Bank’s Articles of Agreement.<sup>1448</sup> Similar provisions also exist for most of the other MDBs as well.<sup>1449</sup> Today, the Bank understands that so long as it is done correctly, fighting corruption is acceptable and necessary in order to fulfil its mandate.<sup>1450</sup> Specifically, the Bank relies on its “fiduciary duty” which implies that the

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<sup>1446</sup> See *Ibid.* at 9-11. This can be seen in specific anti-corruption provisions in the World Bank's Procurement Rules. World Bank, Guidelines: Procurement Under IBRD Loans and IDA Credits § 1.14 (May 1, 2010), available at <http://go.worldbank.org/1KKD1KNT40> [hereinafter World Bank Procurement Guidelines]. Financial reporting, auditing, and other bookkeeping measures are extensively used as means of identifying corruption. See, e.g., The Laws That Govern the Securities Industry, U.S. Sec. & Exchange Commission, <http://www.sec.gov/about/laws.shtml>. Disbursement rules control payment with the goal of preventing World Bank finances being improperly applied. See World Bank Disbursement Guidelines for Projects 5 (2006).

<sup>1447</sup> See International Bank for Research and Development Articles of Agreement art. 1, opened for signature Dec. 27, 1945, 60 Stat. 1440, 2 U.N.T.S. 134 (as amended Feb. 18, 1989) [hereinafter IBRD Articles of Agreement]. The IBRD Articles of Agreement provides as follows: The purposes of the Bank are: (i) To assist in the reconstruction and development. (ii) To promote private foreign investment ....(iii) To promote the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments ....(iv) To arrange the loans made or guaranteed by it in relation to international loans through other channels .... (v) To conduct its operations with due regard to the effect of international investment on business conditions ....Id.; see also IDA Articles of Agreement art. I, done Jan. 26, 1960, 11 U.S.T. 2284, 439 U.N.T.S. 249 [hereinafter IDA Articles of Agreement] (“The purposes of the Association are to promote economic development, increase productivity and thus raise standards of living in the less-developed areas of the world ....”).

<sup>1448</sup> The IBRD Articles of Agreement contain a clause that states that “[t]he Bank and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decisions by the political character of the member or members concerned.” See IBRD Articles of Agreement, *supra* note 1447, art. IV, § 10. The IDA Articles of Agreement maintains provision that is identical. See IDA Articles of Agreement, *supra* note 1447, art. V, § 6.

<sup>1449</sup> Similar provisions are found in the Agreement Establishing the Inter-American Development Bank art. VIII, § 5(f), done Apr. 8, 1959, 10 U.S.T. 3029, 389 U.N.T.S. 69 (as amended July 31, 1995); the Articles of Agreement of the Asian Development Bank art. 36(2), done Dec. 4, 1965, 17 U.S.T. 1418, 571 U.N.T.S. 123; and the Agreement Establishing the African Development Bank art. 38(2), Aug. 4, 1963, 1276 U.N.T.S. 3 (as amended July 5, 2002). On the other hand, the constituent documents of the EBRD and European Investment Bank (EIB) do not contain such restriction. See also Hassane Cissé, Should the Political Prohibition in Charters of International Financial Institutions Be Revisited? The Case of the World Bank, 3 WORLD BANK LEGAL REV. 59, 59-92 (2011).

<sup>1450</sup> Ibrahim F.I. Shihata, Corruption: A General Review with an Emphasis on the Role of the World Bank, 15 DICK. J. INT'L L. 451, 453-58 (1997) (conveying that “the vested interests established through corrupt practices tend to weaken public institutions and delay attempts to reform the system, thus inhibiting the development of new activities and reducing economic growth”); Claes Sandgren, Combating

Bank must ensure that the loans given are used for their intended purposes, and respecting the economy and efficiency.<sup>1451</sup> The Bank, along with other MDBs, now understands that both fraud and corruption weaken development projects and cause harm to the economy in general.<sup>1452</sup>

As such, since the early 1990s, the World Bank began to integrate anti-corruption measures into the Bank's good governance conditionality.<sup>1453</sup> Corruption began to be viewed as a greater issue, and was no longer simply an economic issue in order to better international business transaction, but rather, a serious obstacle in the way of societal development. Nevertheless, in measuring anti-corruption progress, the Bank continues to use a more econometric method.<sup>1454</sup>

According to the World Bank:

“Governance consists of the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them”.<sup>1455</sup>

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Corruption: The Misunderstood Role of Law, 39 INT'L LAW 717, 718 (2005) (arguing that corruption diminishes economic growth).

<sup>1451</sup> See IBRD Articles of Agreement, *supra* note 1447, art. III, § 5(b) (“The Bank shall make arrangements to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency and without regard to political or other non-economic influences or considerations.”); IDA Articles of Agreement, *supra* note 1447, art. V, § 6 (“The Association and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decisions by the political character of the member or members concerned. Only economic considerations shall be relevant to their decisions, and these considerations shall be weighed impartially in order to achieve the purposes stated in this Agreement.”); see also Sanctions Procedures, *supra* note 2, § 1.01(a) (outlining the World Bank's “fiduciary duty” under the Articles of Agreement).

<sup>1452</sup> See President Paul Wolfowitz, Press Briefing with Paul Wolfowitz: IMF/World Bank Group 2006 Annual Meetings (Sept. 15, 2006), available at [http:// web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21053812%EBpagePK:34370%EBpiPK:34424%~-theSitePK:4607,00.html](http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21053812%EBpagePK:34370%EBpiPK:34424%~-theSitePK:4607,00.html) (“[T]he purpose [of the Bank's Strategy Paper on Governance and Anti-Corruption] is not to find a reason to cut back on lending; to the contrary, it is to make the quality of our lending better and to make sure that the lending and grant-making that we do goes where it is supposed to go, which is to help the poorest people of the world.”); David Chaikin & Jason C. Sharman, Corruption and Money Laundering: A Symbiotic Relationship 2 (2009) (providing a review of how corruption is connected to money laundering).

<sup>1453</sup> Courtney Hostetler, Going from Bad to Good: Combating Corporate Corruption on World Bank-Funded Infrastructure Project, 14(1) YALE HUM. RIGHTS & DEVP'T L. J. 231 (2011).

<sup>1454</sup> James Thuo Gathii, Defining the Relationship between Human Rights and Corruption, 31 U. OF PENN. J. OF INT'L L. 125, 127 (2009).

<sup>1455</sup> World Bank, Worldwide Governance Indicators, [http:// info.worldbank.org/governance/wgi/resources.htm](http://info.worldbank.org/governance/wgi/resources.htm).

There are six governance indicators in which the Bank examines when measuring a country's governance score, this includes the management of corruption.<sup>1456</sup> The World Bank's attention to good governance was reinforced by works which explained the foundations of corruption based on the behaviour of governments. These studies proclaimed that various governmental policies often increase corrupt practices.<sup>1457</sup> Such policies that were found included trade restrictions, governmental subsidies, price controls, low wages in the civil service, and licensing requirements (particularly if it was left to only certain officials or departments to grant).<sup>1458</sup> Given that these policies could encourage rent-seeking, the Bank sought to correct these ailments through conditionality and deregulation.<sup>1459</sup> Nevertheless, other factors also prompt rent-seeking, which are often not related to governmental policies and thus, outside of the World Bank's reach.<sup>1460</sup>

In realizing the effects of corruption and the need for good governance, the World Bank began its sanctions system, which many of the MDBs have adopted or modelled their own after. The sanctions system's primary goal is to safeguard the Banks' funds in furtherance of its fiduciary duty, which is where both its legal basis and scope is derived from. This goal demonstrates that the purpose of the sanctions system is not really to punish, but principally to protect the Bank's financing by excluding those who have corrupt

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<sup>1456</sup> See *id.* (listing the other five indicators which are: (i) voice and accountability; (ii) political stability and absence of violence/terrorism; (iii) government effectiveness; (iv) regulatory quality; and (v) rule of law).

<sup>1457</sup> Paolo Mauro, *The Effects of Corruption on Growth and Public Expenditure*, in *Political Corruption: Concept & Contexts*, (Third Edition, 2002) 339, 341-42.

<sup>1458</sup> Susan Rose-Ackerman, *When Is Corruption Harmful?* in *Political Corruption: Concept & Contexts* (Third Edition, 2002) 353, 355, 358 (arguing that in giving the authority to provide licenses to a central body it can promote efficiency on the one hand, however on the other hand, if officials know that there is no other way to get a license the officials may be more likely to accept bribes).

<sup>1459</sup> World Bank, *Strengthening Governance: Tackling Corruption--The World Bank Group's Updated Strategy and Implementation Plan 7* (Report, 6 March 2012) (reiterating its strategy on corruption and good governance and finding that "anti-corruption strategies without effective broader governance strategies are unlikely to succeed"). This updated strategy relies less on the notion of implementing a one-size-fits-all conditions and blanket deregulation, noting that, "a modest global [governance and anti-corruption] program based on the World Bank's role as convener, connector and generator of knowledge", *id.* at 4; "[World] Bank clients demand services and borrow to fund their own priorities and to meet their own aspirations", *ibid.* at 20.

<sup>1460</sup> Jan Wouters, et al., *The International Legal Framework Against Corruption: Achievements and Challenges*, 14 *Melb. J. Int'l L.* 205, 231 (2013) (listing other factors which enhance corruptive practices and rent-seeking which include sociological ones, such as strong family ties and ethnic diversity).

practice and more so, to deter misconduct related to the proceeds.<sup>1461</sup> The Bank's method in fighting corruption has thus become to focus on denying funding to those parties that are found to have engaged in sanctionable practices.

The sanctions regime as it stands today is the product of continuous developments in international financial institutions. An initial beginning for the sanctions regime began in 1996, following James Wolfensohn's famous "cancer of corruption" speech.<sup>1462</sup> Also around that time, other multilateral organizations, such as the United Nations (UN) and the Organization for Economic Cooperation and Development (OECD), commenced policy work on corruption, including the initial development of the UN and OECD conventions on corruption. Wolfensohn encouraged the anticorruption scheme in many ways including leading to the development of cross-country data sources, background information for corruption indices, procurement systems and integrity mechanisms in general, nevertheless, it appears that country responsibility of these measures was not taken into account.<sup>1463</sup>

The sanction process did not incorporate measures involving the governments that were supposed to control the funds, nor was it based on efforts to improve their criminal justice systems. The World Bank thus responded to cases of corruption in its projects as issues to be sanctioned and solved internally (through using its own system) instead of as a problem to be examined in the larger context of corruption in recipient governments.<sup>1464</sup>

The World Bank assigned Dick Thornburgh, along with a group of experts, to assess its sanctions system in terms of efficiency, fairness, and transparency and to also make any recommendations needed. The assessment became known as the Thornburgh report and it significantly influenced the design of the sanctions regime, especially with in terms of fairness of procedures and the position of the sanctions-determining body vis-à-

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<sup>1461</sup> See, e.g., The World Bank's Sanctions System: Tackling Corruption Through a Two-Tier Administrative Sanctions Process, World Bank, [http:// go.worldbank.org/EB6JXKU4Z0](http://go.worldbank.org/EB6JXKU4Z0).

<sup>1462</sup> James Wolfensohn, People and Development (Speech delivered at the Annual Meeting of the World Bank and International Monetary Fund, Washington DC, 1 October 1996), available at <http://go.worldbank.org/PUC5BB8060>.

<sup>1463</sup> Tina Soreide et al., An Efficient Anticorruption Sanctions Regime? The Case of the World Bank (Working Paper, 2015)

<sup>1464</sup> Ibid.

vis investigations. The Report also aided to establish the protection of funds as the main purpose of the regime.<sup>1465</sup>

### **The MDBs harmonization and furtherance of anticorruption**

After the Thornburgh Report and several internal reviews, the Bank began to further the sanctions regime by developing definitions, strategies, and procedures for imposing sanctions.<sup>1466</sup> This section explores the regime more in depth in order to examine the ways it can be improved and to develop criticisms on its functioning.

In 2006, as a means to harmonize efforts of the MDBs against corruption and fraud, the five above mentioned MDBs, along with the International Monetary Fund and the European Investment Bank (EIB), formed the International Financial Institutions Anti-Corruption Task Force (“the Task Force”). By publishing their recommendations and with each institution endorsing the document, it became an essential first step in unifying the MDB’s efforts against corruption.<sup>1467</sup> The document, the Uniform Framework for Preventing and Combating Fraud (“Uniform Framework”) harmonized definitions for sanctionable practices to be used by the participating financial institutions. It also contained a commitment to harmonize the investigative procedures and also explore whether debarment decisions from one institution should be recognized by the others. The Uniform Framework recognizes four sanctionable practices: corrupt practice, fraudulent practice, coercive practice, and collusive practice. Moreover, in addition to these four practices, each of ADB, IADB and WB also incorporate obstructive practice in their sanctions regime.<sup>1468</sup> These practices are defines as follows:

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<sup>1465</sup> Dick Thornburgh et al., Report Concerning the Debarment Processes of the World Bank (2002).

<sup>1466</sup> Integrity Vice Presidency, The World Bank Group Integrity Vice Presidency Annual Update: Fiscal Year 2014, World Bank, <http://documents.worldbank.org/curated/en/2014/01/20274019/world-bank-group-integrity-vicepresidency-annual-update-fiscal-year-2014>.

<sup>1467</sup> Uniform Framework for Preventing and Combating Fraud and Corruption [hereinafter Uniform Framework], available at <http://www.ebrd.com/downloads/integrity/task.pdf>.

<sup>1468</sup> See World Bank Sanctions Procedures (April 15, 2015) [hereinafter Sanctions Procedures], available at [http://siteresources.worldbank.org/EXTOFFEVASUS/Resources/WB\\_Sanctions\\_Procedures\\_Jan\\_2011\\_\(with\\_July\\_2011\\_Amendments\).pdf](http://siteresources.worldbank.org/EXTOFFEVASUS/Resources/WB_Sanctions_Procedures_Jan_2011_(with_July_2011_Amendments).pdf), the ‘Sanctions Practice’ definition, at 4; Asian Development Bank, Anticorruption and Integrity, Second Edition (October 2010) [hereinafter ADB Procedures], available at <http://www.adb.org/Documents/Policies/Anticorruption-Integrity/anticorruption-integrity-policystrategy.pdf>, at 4; and Sanctions Procedures of the Inter-American



1. A corrupt practice “is the offering, giving, receiving or soliciting, directly or indirectly, of anything of value to influence improperly the actions of another party.”<sup>1469</sup> This is considered to occur irrespective of whether the illicit act was accepted or received or whether “the purpose of the payment was achieved.”<sup>1470</sup> The definition encompasses a prohibition of both active and passive bribery. “[T]he definition of corrupt practice is not limited to the prohibited activity during the procurement process but extends to bribery during the execution of the contract.”<sup>1471</sup> Bribery may also be used as a means to incorporate lenient contractual clauses for enforcement or in relation to a number of other issues such as product quality or the use of subcontractors.<sup>1472</sup> Prime examples of corrupt practice often include officials being bribed to be placed on the short list or providing information, often of a confidential nature, regarding the criteria for selection process.<sup>1473</sup> This can occur when an individual or entity is granted a government contract financed by the World Bank and a bribe of some sort is offered to the government official who directed the contract to the individual or entity.<sup>1474</sup>
2. A *fraudulent practice* “is any act or omission, including a misrepresentation, that knowingly or recklessly misleads, or attempts to mislead, a party to obtain

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Development Bank [hereinafter IADB Procedures], available at <http://idbdocs.iadb.org/wsddocs/getdocument.aspx?docnum=36233155>, x2.2. Of note, the EBRD does not recognize ‘obstructive practice’ as a sanctionable practice on its own. Arguably, the four practices defined in the Uniform Framework concern wrongdoings in the context of an MDB operation, while ‘obstructive practice’ concerns actions in the course of proceedings carried out by an MDB in order to ascertain such wrongdoings.

<sup>1469</sup> World Bank, The World Bank's Anti-Corruption Guidelines and Sanctions Reform: A User's Guide, at 5 (Oct. 15, 2006), available at [http://siteresources.worldbank.org/PROJECTS/Resources/40940-1173795340221/EnglishFinalAnti\\_CorruptionGuidelines5\\_05\\_08nd.pdf](http://siteresources.worldbank.org/PROJECTS/Resources/40940-1173795340221/EnglishFinalAnti_CorruptionGuidelines5_05_08nd.pdf) [hereinafter Anti-Corruption Guidelines].

<sup>1470</sup> *Ibid.* at 9

<sup>1471</sup> Sope Williams, The Debarment of Corrupt Contractors from World Bank-Financed Contracts, 36 Pub. Cont. L. J. 277, 287 (2007).

<sup>1472</sup> *Ibid.*

<sup>1473</sup> Anti-Corruption Guidelines, *supra* note 1469, attachment P7(a); Press Release, World Bank, Statement: World Bank Group Discloses Debarments under Corporate Procurement Program, No.2009/198/EXC (Jan. 11, 2009), available at <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:22030864~pagePK:64257043~piPK:437376~theSitePK:4607,00.html>.

<sup>1474</sup> Anti-Corruption Guidelines, *supra* note 1469, at 6.

a financial or other benefit or to avoid an obligation.”<sup>1475</sup> Generally, any material misrepresentation or omission of material information is classified as a fraudulent practice. A negligent or innocent misrepresentation or omission does not normally count as a violation.<sup>1476</sup> The action must be done knowingly or in a manner that is “recklessly indifferent as to whether [the information] is true or false.”<sup>1477</sup> An illustration of a fraudulent practice would occur when a firm or consultant has misrepresented their credentials or expertise in order to be selected for the procurement process.<sup>1478</sup> This could include misrepresenting experience or facts in proposals or falsifying or forging documents in support of proposals.<sup>1479</sup> More illustrations include “financial misrepresentations, the falsification of contract implementation information and accounting records, the tender of misleading bids, malicious frontloading of contract prices, overbilling, and the alteration of invoices or other supporting documents.”<sup>1480</sup> It also applies to “any document-based change designed to manipulate or alter procurement or contractual outcomes.”<sup>1481</sup> Suppressing information about material conflicts of interest could also qualify.

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<sup>1475</sup> Ibid.; see also Press Release, World Bank, World Bank Debars Four for Engaging in Fraud in Bank-Financed Projects, No. 2009/375/INT (June 2, 2009), available at <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,contentMDK:22198025~pagePK:64257043~piPK:437376~theSitePK:4607,00.html?cid=3001> (debaring an entity and its principle attempting to secure a contract due to submitting false bank references).

<sup>1476</sup> “To act, ‘knowingly or recklessly,’ the fraudulent actor must either know that the information or impression being conveyed is false, or be recklessly indifferent as to whether it is true or false. Mere inaccuracy in such information or impression, committed through simple negligence, is not enough to constitute a fraudulent practice.” Anti-Corruption Guidelines, *supra* note 1469, at 5, n.10.

<sup>1477</sup> Ibid.

<sup>1478</sup> Ibid. at 6-7.

<sup>1479</sup> See Press Release, World Bank, Croatia: World Bank Sanctions BIS Healthcare Group in a Health Reform Project (Nov. 22, 2004), available at <http://go.worldbank.org/HKCFUV3NA1> (debaring a company and its principal for misrepresenting their experience and qualifications); Press Release, World Bank, World Bank Debars Firm, Individual For Fraudulent Practices Under Russian Federation Community Social Infrastructure Project, No. 2006/343/ECA (Mar. 30, 2006), available at <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20870134~menuPK:34463~pagePK:34370~piPK:34424~theSitePK:4607,00.html> (debaring because of forging a manufacturer's letter of authorization and for misrepresenting information in corporate documents).

<sup>1480</sup> Williams, *supra* note 1471, at 287.

<sup>1481</sup> Ibid. ta 287-88.

3. A *collusive practice* “is an arrangement between two or more parties designed to achieve an improper purpose, including influencing improperly the actions of another party.”<sup>1482</sup> Collusive practice is often found where an individual or entity works with other individuals or entities to manipulate the system to achieve an improper result.<sup>1483</sup> It also comprises of situations where an individual or entity works with others to direct a contract award to a particular individual or entity.<sup>1484</sup> Hindering competition can be classified as collusive practice. Manipulating the requirements for a request for proposal so as to exclude others would be an example of collusion, as would situations where parties work in tandem to actively and maliciously impede others from having an opportunity to bid on a potential contract.<sup>1485</sup> A collusive practice can be an arrangement among possible suppliers wherein they agree, before bids are submitted, on a price over and beyond what are competitive and decide who among their number will submit the winning bid, still artificially high, while the other suppliers submit extremely high bids (that have no chance of winning).<sup>1486</sup> In such a situation, the proceeds may be shared among the suppliers or possibly through a rotation system to facilitate the bids of other suppliers.<sup>1487</sup>
  
4. A *coercive practice* “is impairing or harming, or threatening to impair or harm, directly or indirectly, any party or the property of the party to influence improperly the actions of a party.”<sup>1488</sup> An example of a coercive practice is

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<sup>1482</sup> Anti-Corruption Guidelines, supra note 1469, at 8.

<sup>1483</sup> Ibid, see Press Release, World Bank, World Bank Debars Seven Firms and One Individual for Collusive Practices Under Philippines Roads Project, No: 2009/200/INT (Jan. 14, 2009), available at <http://go.worldbank.org/BKL6BASPQ0> [hereinafter Press Release 2009/200/INT] (sanctioning firms after it was determined that they “had participated in a collusive scheme designed to establish bid prices at artificial, non-competitive levels and to deprive the [World Bank] Borrower of the benefits of free and open competition”).

<sup>1484</sup> Anti-Corruption Guidelines, supra note 1469, at 8.

<sup>1485</sup> Ibid.

<sup>1486</sup> Williams, supra note 1471, at 287.

<sup>1487</sup> Ibid.; see Press Release, World Bank, Timor-Leste: World Bank Sanctions Companies in School Project (Nov. 22, 2004), available at [http:// go.worldbank.org/QEQ0NUN3O0](http://go.worldbank.org/QEQ0NUN3O0) (debaring companies for finding collusive practice to disburse various lots of furniture by deciding which company would have the lowest bid).

<sup>1488</sup> Anti-Corruption Guidelines, supra note 1469, at 7.

taking measures to thwart a competitor from submitting a timely bid. Also included is applying undue pressure on decision makers.<sup>1489</sup>

5. An *obstructive practice* “is (i) deliberately destroying, falsifying, altering or concealing of evidence material to the investigation or making false statements to investigators in order to materially impede a [World] Bank investigation into allegations of a corrupt, fraudulent, coercive or collusive practice; and/or threatening, harassing or intimidating any party to prevent it from disclosing its knowledge of matters relevant to the investigation or from pursuing the investigation, or any combination of the foregoing, or (ii) acts intended to materially impede the exercise of the [World] Bank's contractual rights of audit or access to information.”<sup>1490</sup> One example is when an entity, that has been awarded a contract, fails to present documents when the World Bank has requested a review of the entity’s records.<sup>1491</sup>

As can be noted, the prohibited practices are broadly defined and offer the MDBs with a wide margin to sanction individuals and entities. Furthermore, in addition to harmonizing the definitions of prohibited practices, the Uniform Framework also provided agreed upon minimum standards that each MDB must take to conduct investigations.

When corrupt practices have been uncovered, the MDBs may select from a variety of sanctions to impose on the individual or entity:

1. Public Letter of Reprimand, which is issued to the sanctioned party.<sup>1492</sup>
2. Debarment, “which means that the sanctioned party is barred, effective immediately, from participating in [World] Bank projects, either indefinitely or for a period of time.”<sup>1493</sup>
3. Conditional Non-Debarment, which means that the sanctioned party is told that they will be debarred unless they comply with certain conditions, i.e., doing certain things to make sure that fraud and corruption does not happen again, such as putting

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<sup>1489</sup> Ibid.

<sup>1490</sup> Ibid.

<sup>1491</sup> Ibid.

<sup>1492</sup> Ibid.

<sup>1493</sup> Ibid.

- in place an ethics program, and/or making up for the damage caused by their actions, such as restitution.<sup>1494</sup>
4. Debarment with Conditional Release, “which means that the sanctioned party is debarred until the specified conditions has been complied with.”<sup>1495</sup>
  5. Restitution, “which means paying back the ill-gotten gains to the government or to the victim of the fraud and corruption.”<sup>1496</sup>

When deciding on the outcome of a case, one or more sanctions, including cumulative sanctions, may be imposed.<sup>1497</sup> The sanctions may also be imposed on any affiliate of the one that is under proceedings.<sup>1498</sup> Additionally, sanctions will also apply to any successors and assigns, as determined by the proceedings.<sup>1499</sup> There are several factors that may be deliberated in the imposition of sanctions which include, among others: the severity of the misconduct;<sup>1500</sup> the magnitude of harm caused;<sup>1501</sup> inferring in the investigation of the alleged practices;<sup>1502</sup> the past history of sanctionable conduct;<sup>1503</sup> mitigating circumstances such as cooperation in investigation;<sup>1504</sup> any breach of confidentiality of the sanctions proceedings.<sup>1505</sup> In order to strengthen their efforts to combat corruption, the MDBs decided to sign the Agreement for Mutual Enforcement of Debarment Decisions (“Mutual Enforcement Agreement”).<sup>1506</sup> This significantly enhanced the sanctions regime that the MDBs would impose. Any entity found to have

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<sup>1494</sup> Ibid.

<sup>1495</sup> Ibid. see Press Release, World Bank, World Bank Sanctions Lahmeyer International for Corrupt Activities in Bank-Financed Projects, No. 129/2007/INT (Nov. 6, 2006), available at <http://go.worldbank.org/7DBYL7MON0> (convicting both Lahmeyer International GmbH and the recipient of a bribe but debarment sentence was to be reduced by four years if Lahmeyer International “puts in place a satisfactory corporate compliance and ethics program and cooperates fully ... in disclosing any past misconduct ....”).

<sup>1496</sup> Anti-Corruption Guidelines, supra note 1469, at 14.

<sup>1497</sup> Sanctions Procedures, supra note 1468, at § 9.902. This does not include when there is a violation of a Material Term of the VDP Terms and Conditions which leads to a mandatory ten year debarment.

<sup>1498</sup> Ibid. at § 9.904(b).

<sup>1499</sup> Ibid. at § 9.904(c).

<sup>1500</sup> Ibid. at § 9.902(a).

<sup>1501</sup> Ibid. at § 9.902(b).

<sup>1502</sup> Ibid. at § 9.902(c).

<sup>1503</sup> Ibid. at § 9.902(d).

<sup>1504</sup> Ibid. at § 9.902(e).

<sup>1505</sup> Ibid. at § 9.902(f).

<sup>1506</sup> Agreement for Mutual Enforcement of Debarment Decisions, 9 April 2010, available at <http://www.ebrd.com/downloads/integrity/Debar.pdf>. The Agreement was signed by AfDB, ADB, EBRD, EIB, IADB, and WB.

engaged in any of the corrupt practices recognized by the MDBs which results in debarment will be enforced by the other participating MDBs.

The Mutual Enforcement Agreement is founded on six core principles that are shared by its signatories as a pledge that their tasks are not to be compromised by corrupt behaviour:

1. adoption of harmonized definitions of sanctionable (also known as prohibited) practices, which include (i) fraudulent practice, (ii) corrupt practice, (iii) coercive practice, and (iv) collusive practice,<sup>1507</sup> as described above;
2. adherence to uniform investigatory procedures that ensure fair, impartial and thorough investigations;<sup>1508</sup>
3. instituting internal authorities responsible for the investigative function
4. and a distinct decision-making authority;<sup>1509</sup>
5. publication of written procedures that require (a) notice to entities and/or individuals against whom the allegations are made and (b) an opportunity for those entities and/or individuals to respond to the allegations;<sup>1510</sup>
6. employ the use of the “more probable than not” standard in assessing sanctions violations;<sup>1511</sup> and
7. provide for a range of sanctions that are proportional and incorporate mitigating and aggravating factors.<sup>1512</sup>

There are limitations to the Mutual Enforcement Agreement, however. For instance, only those debarment decisions that are made public<sup>1513</sup> by the sanctioning institution, that exceed one year,<sup>1514</sup> and those decisions that were made within ten years of sanctionable behaviour are to be recognized across the signatories.<sup>1515</sup> The Mutual Enforcement Agreement does not affect decisions made based on a national or international

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<sup>1507</sup> Ibid. at § 2(a).

<sup>1508</sup> Ibid. at § 2(b).

<sup>1509</sup> Ibid. at § 2(c)(i).

<sup>1510</sup> Ibid. at § 2(c)(ii).

<sup>1511</sup> Ibid. at § 2(c)(iii).

<sup>1512</sup> Ibid. at § 2(c)(iv).

<sup>1513</sup> Ibid. at § 4(b).

<sup>1514</sup> Ibid. at § 4(c).

<sup>1515</sup> Ibid. at § 4(e).

forum.<sup>1516</sup> Moreover, if a MDBs decision is in conflict with another’s legal or institutional considerations, it may decline to enforce the decision.<sup>1517</sup> Nevertheless, an opt-out decision of one MDB does not affect the obligations of the others. If in case a MDB decides this, it must promptly notify the others of its decision. Lastly, the Mutual Enforcement agreement does not prevent a MDB from conducting independent sanction proceedings which may result in “concurrent, consecutive or subsequent periods of debarment” for entities and individuals engaging in sanctionable practices.<sup>1518</sup>

The MDBs took further steps to harmonize their efforts in 2012 as well. The first document, signed by the five MDBs, along with the EIB, was done in order to “harmonize their respective sanctioning guidelines, to ensure consistent treatment of individuals and firms.”<sup>1519</sup> After reviewing certain aspects of the Mutual Enforcement Agreement, the document recognizes the sanctions discussed above that may be imposed singularly or in combination. In introducing the sanctions of conditional non-debarment and debarment with conditional release into the MDB harmonized regime, there was a strong incentive for entities and individuals to work on improving compliance measures. A further step to harmonization in the future may be for the MDBs to agree upon a set of integrity compliance measures or guidelines. In doing so, the MDBs may improve the likelihood of the application of rehabilitation measures among vendors/bidders and other entities.<sup>1520</sup>

An additional feature of the document is that it raises interest is the identification of debarment for three years (with or without conditional release) as the base sanction.<sup>1521</sup> This was an important step in harmonizing the manner in which the MDBs apply their procedures. The document also provides a table that recognizes the possible increases or

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<sup>1516</sup> Ibid. at § 4(f).

<sup>1517</sup> Ibid. at § 6.

<sup>1518</sup> Ibid. at § 7.

<sup>1519</sup> General Principles and Guidelines for Sanctions, available at [http://lnadbg4.adb.org/oai001p.nsf/0/CE3A1AB934F345F048257ACC002D8448/\\$FILE/Harmonized%20Sanctioning%20Guidelines.pdf](http://lnadbg4.adb.org/oai001p.nsf/0/CE3A1AB934F345F048257ACC002D8448/$FILE/Harmonized%20Sanctioning%20Guidelines.pdf)

<sup>1520</sup> Lorenzo Nesti, The 2010 Agreement on Mutual Enforcement of Debarment Decisions and its Impact for the Fight Against Fraud and Corruption in Public Procurement, 14 J. of Pub. Procurement 62, 70 (2014).

<sup>1521</sup> General Principles and Guidelines for Sanctions, *supra* note 1519, ¶ 4.

decreases to the base sanction as a result of aggravating circumstances<sup>1522</sup> or mitigating factors.<sup>1523</sup> Lastly, the document covers settlements, leaving the door open for the introduction of this important instrument also by other MDBs besides the WBG. While these General Principles and Guidelines for Sanctions are not to be considered prescriptive in all areas (such as with settlements), it is explicitly foreseen that the standards set out by them should be incorporated by each participating MDB in its sanctioning policies.<sup>1524</sup>

The MDBs also collaborated on a second document that harmonized the principles for the treatment of corporate groups.<sup>1525</sup> The Corporate Groups documents were set up to be a set principles “intended as guidance to the Institutions as they develop their own applicable policies and procedures.”<sup>1526</sup> It provides guidance on the application of sanctions to entities controlled by the accused party (also known as the Respondent).<sup>1527</sup> The document’s guidance explains how sanctions typically apply to entities controlling the Respondent or entities under the same control as the Respondent. However, in such a case, the participating MDB has the burden of proof of establishing the involvement of these entities in the prohibited practices. Furthermore, the harmonized principles provide guidance on how to apply a sanction to successors and assigns in cases of acquisitions, mergers or reorganizations.<sup>1528</sup> In regard to corporate groups in cross-debarment, the document establishes that only those entities identified by name by the MDB can be subject to cross-debarment. The harmonization for corporate groups is very important given it addresses various issues which liability of corporate conduct may pose.

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<sup>1522</sup> Ibid.at ¶ 5. For example: the severity of the prohibited conduct, the harm caused by it, an interference with the investigation or obstruction of the investigative process, a past history of sanctions or the violation of a previous sanction or temporary suspension.

<sup>1523</sup> Ibid. For example: a minor role of the sanctioned entity/individual in the prohibited conduct, a voluntary corrective action taken by the sanctioned entity/individual or the cooperation by the latter with the investigation.

<sup>1524</sup> Nesti, *supra* 1520, at 71.

<sup>1525</sup> MDB Harmonized Principles on Treatment of Corporate Groups (Sept. 10, 2012), available at [http://lnadbg4.adb.org/oai001p.nsf/0/A7912C61C52A85AD48257ACC002DB7EE/\\$FILE/MDB%20Harmonized%20Principles%20on%20Treatment%20of%20Corporate%20Groups.pdf](http://lnadbg4.adb.org/oai001p.nsf/0/A7912C61C52A85AD48257ACC002DB7EE/$FILE/MDB%20Harmonized%20Principles%20on%20Treatment%20of%20Corporate%20Groups.pdf)

<sup>1526</sup> Ibid.

<sup>1527</sup> Ibid.

<sup>1528</sup> Ibid. The Principles of Corporate Groups provide guidance on the means and procedures for the prevention of attempts to circumvent sanctions by the creation or acquisition of a new entity. The document also clarifies which factors should be considered in determining the type and severity of the sanction to be imposed on any Respondent or other entity subject to a sanction (different sanctions may be imposed to different entities within a corporate group).



Although the MDBs moved forward with major harmonization areas, there are more that can be addressed to further their efforts and unify their goals. As will be discussed below, the MDBs should consider harmonizing efforts in aiding local governments take on corruption challenges themselves. Transparency as well can be harmonized in terms of the amount of information that is made publicly available by the MDBs.

### **Due process in the sanctions regime**

Exercising their legal power in a sanctions regime is a step towards MDBs practicing a procedure that is generally left to national systems. The World Bank has reiterated that the system is fundamentally administratively based.<sup>1529</sup> Nevertheless, in examining the type of sanctioned practices that are regulated, the wide scope of the sanctions and the independence of the investigating system, and taking into consideration the types of national remedies it takes the place of, it appears that the MDB sanction regime can seem similar to criminal justice practices.<sup>1530</sup>

At any rate, due process procedures are given substantial consideration by the MDBs in order to ensure fairness, regularity, and transparency. The Integrity Vice President (INT) at the World Bank is responsible for investigating alleged corrupt practice. The INT is not limited to the procurement process, as its jurisdiction can extend to other areas of the Bank's practices.<sup>1531</sup> In carrying out its duties, the INT must adhere to the institutional framework that is designed to ensure due process. For instance, the INT submits the evidence found to the Evaluation and Suspension Officer (EO) when then

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<sup>1529</sup> Ann Marie Lory & Frank A. Fariello, *The World Bank Group Sanctions Process and Its Recent Reforms* (2012).

<sup>1530</sup> In a foreign bribery case, the Supreme Court of Norway concluded that no additional criminal sanctions should be imposed on the company given "the act had resulted in extensive reactions from the World Bank." Considering the likelihood of further debarment from public procurement, the court decided to leave out corporate penalty since "viewed collectively [it] might have disproportionate consequences for the company." see HR-2013-1394-A, case no. 2012/2114), Norconsult: <http://www.domstol.no/en/Enkelt-domstol/-Norges-Hoyesterett/Summary-of-Recent-Supreme-Court-Decisions/Summary-of-Supreme-Court-Decisions-2013/>.

<sup>1531</sup> Sanctions Procedures, *supra* note 1468, at pt. I, P (c) (noting the INT can investigate into investment projects, non-compliance with third party audit rights, and obstruction of corruption investigations).

determines “whether there is sufficient evidence to support a finding” that the entity or individual has engaged in a sanctionable practice and whether to continue the adjudicatory process.<sup>1532</sup> This can be seen as functioning as a checks and balances, not one unit is given authority to make such decisions. Such due process measures are beneficial not only for creating legal certainty, but for safeguarding the sanctions process in general. Often times, the accused entity is debarred the moment the process begins when the EO issues a notification that there is an adjudicatory process to go underway.<sup>1533</sup> There is also an opportunity for the accused to reach a settlement in which the accused and INT agree about the charge, the sanction, and what is to be publicized, in exchange for information, implementing a strong compliance system, and supervising the supplier’s operations.<sup>1534</sup>

The sanctions regime also enables the accused to appeal a decision by the INT to the Sanctions Board – which embodies the second step of the adjudicatory process.<sup>1535</sup> The Sanctions Board is made up of three members of the World Bank staff and four external members.<sup>1536</sup> The Board functions as a sort of appeals court – as a means to maintain due process through the sanctions procedure. The sanctions regime overall applies a low standard of evidence, “more likely than not” when determining guilt.<sup>1537</sup> Accordingly, it entails a weak presumption of innocence. In considering this, the regime can be likened to procurement law debarment regimes maintained by state administrations, where suspected crime (and not conviction) in many cases will prove a satisfactory basis for determining a supplier ineligible to participate in a tender.

Additional formal rules of evidence do not apply in these proceedings.<sup>1538</sup> “Any kind of evidence may form the basis of arguments presented in a sanctions proceeding.”<sup>1539</sup>

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<sup>1532</sup> Ibid. § 9(1).

<sup>1533</sup> Ibid. § 9(6).

<sup>1534</sup> Ibid. § 11.

<sup>1535</sup> Ibid. § 8.

<sup>1536</sup> Int’l Bank for Reconstruction & Dev. & Int’l Dev. Ass’n Int’l Fin. Corp. and Multilateral Ins. Guarantee Agency, Sanctions Board Statute, art. V (Dec. 2006), available at [http://www.ifc.org/ifcext/anticorruption.nsf/AttachmentsByTitle/Sanctions\\_Statute/\\$FILE/Sanctions\\_Statute.pdf](http://www.ifc.org/ifcext/anticorruption.nsf/AttachmentsByTitle/Sanctions_Statute/$FILE/Sanctions_Statute.pdf).

<sup>1537</sup> Sanctions Procedures, *supra* note 1468, at § 8.

<sup>1538</sup> Ibid. art. VII.

<sup>1539</sup> Ibid.

In addition, “[h]earsay evidence or documentary evidence shall be given the weight deemed appropriate.”<sup>1540</sup> Purpose, intent, and knowledge may be inferred from circumstantial evidence. “A party's refusal to answer, or failure to answer truthfully or credibly, may be construed against that party.”<sup>1541</sup> Communications subject to the attorney-client privilege or the attorney work product doctrine are protected and not subject to disclosure. The sanctioned party's identity and sanctions imposed are publicly disclosed.<sup>1542</sup> Information acquired from the sanctions proceedings may be provided to governmental authorities, international organizations, or other development banks. Disclosure can also transpire before the determination of culpability of an individual or entity. Prior notice of disclosure is also not required, nor is there a means of precluding such disclosures. Limitations on disclosures to governments or international organizations may be imposed if “there is a reasonable basis that revealing the information might endanger the life, health, safety, or well-being of a person” or violate an understanding associated with the Voluntary Disclosure Program (VDP).<sup>1543</sup>

The World Bank’s Legal Vice Presidency (LEG) continues to try and make the sanctions regime more efficient and effective, and also to try and increase transparency and fairness. At the moment, sanctions are made open to the public to some extent. While those entities that are debarred are officially blacklisted, little is known about the negotiated settlements that occur or even the conditional non-debarment sanctions. Although the Bank exhibits levels of transparency above what other international financial institutions or organizations, LEG examines how to enhance transparency even more.<sup>1544</sup> This is also tied to LEG increasing due process procedures because it has recognized the increasing sophistication and quasi-judicial nature of the regime.<sup>1545</sup> As such, it would be welcomed to have continued efforts to increase transparency of the system.

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<sup>1540</sup> Ibid.

<sup>1541</sup> Ibid.

<sup>1542</sup> Ibid. art. X.

<sup>1543</sup> Ibid. THE VDP is a system that allows an individual or entity to undergo remedial action by coming forth regarding conduct that (1) may be an obstacle to obtaining opportunities at the World Bank or (2) that may lead to the composition of sanctions for projects currently underway.

<sup>1544</sup> See generally Conrad Daly & Frank Fariello, *Transforming Through Transparency: Opening up the Bank's Sanctions Regime*, 4 *World Bank Legal Rev.* 101, 101-21 (2012) (examining the development and “opening up” of the World Bank's sanctions regime to bolster greater transparency and accountability).

<sup>1545</sup> See, e.g., *id.* at 19 (commenting on the Bank's care and attention to due process and the rule of law).

## **The World Bank and MDBs should harmonize efforts to build up local governments**

There is no doubt that the MDBs are continuously working to the aim of combating corruption and that the forerunner of them all is the World Bank. As noted earlier, the Sanctions Procedures lays out the Bank's fiduciary duty, the legal basis for the sanctions regime, stating that its purpose is to protect Bank's funds and to work as "a deterrent upon those who might otherwise engage in the misuse of the proceeds of Bank financing."<sup>1546</sup> However, in analysing the sanctions regime it is clear that there is still a lot left to do.

In abiding by its fiduciary duty, the bank must ensure stronger safeguards against itself. That is, it must implement due diligence for itself if it is to succeed in the fight against corruption. The Bank loans billions of dollars to development projects a year which falls into corrupt hands.<sup>1547</sup> In light of this statistic, the preventative advice that the World Bank extends to developing countries is not very effective. Though the World Bank notes that it has "helped build precautions ... against corruption" into various high-risk projects, these precautions came in the form of advice, not due diligence on its own part.<sup>1548</sup> This is not to say that the Bank has not helped some governments in uncovering and preventing corrupt practices,<sup>1549</sup> but the advice provided by the Bank is only given on a limited basis. Between the years 2009 to 2011, the Bank only offered advice to governments regarding integrity-compliance about thirty times.<sup>1550</sup> The infrequency the Bank offers advice may be a

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<sup>1546</sup> Sanctions Procedures, *supra* note 1468, at § 1.

<sup>1547</sup> See World Bank, Stolen Assets and Development, [http://www1.worldbank.org/finance/star\\_site/stolen-assets.html](http://www1.worldbank.org/finance/star_site/stolen-assets.html) (providing a conservative estimate that between \$20 to \$20 billion is stolen from developing countries each year, which comprises about 20 to 40 percent of annual international development assistance).

<sup>1548</sup> The World Bank Group Integrity Vice Presidency, Annual Report: Finding the Right Balance 12 (2012), available at [http://siteresources.worldbank.org/EXTDOI/Resources/WBG\\_IntegrityReport2012.pdf](http://siteresources.worldbank.org/EXTDOI/Resources/WBG_IntegrityReport2012.pdf). The World Bank uses the word "advice" to describe the precautions that it took against corruption in high-risk projects. *Id.* While it instructed borrowing countries about performing due diligence, it does not indicate that it performed due diligence itself. *Id.* at 24.

<sup>1549</sup> See *Ibid.* at 22 (conveying how the World Bank's advice has thwarted corruption in developmental projects).

<sup>1550</sup> Between 2009 and 2011, the World Bank Group Integrity Vice Presidency made 129 recommendations in total, only 23 percent of which it directed toward borrowing countries. *Id.* at 24.

realization that simply discussing anticorruption to corrupt governments does little to fight it:

There is something of an ‘Alice in Wonderland’ quality to the idea that a foreign-aid agency can provide money to a corrupt foreign government for the express purpose of reducing corruption and then expect the objective to be attained. Corrupt governments have zero incentive to reform their ways when provided with huge amounts of foreign cash. More likely, they will just steal the cash.<sup>1551</sup>

Yet, there is a slight conflict of interest found within the system also. Could it be that there is not a strong enough inclination to fight corruption with the governments given success and promotions are dependent on the amount of loans that are approved, not the number of projects that go under investigation.<sup>1552</sup> There is a direct problem with an anticorruption mission when interest can still be earned or accelerated payment can occur on a loan with stolen funds.<sup>1553</sup> When viewing the picture as a whole, internal incentives such as these may help explain why the Bank offers more advice to governments rather than setting up due diligence for itself. This could lead the Bank to becoming a greater contributor rather than a fighter of corruption.<sup>1554</sup> The World Bank, as the provider of the

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<sup>1551</sup> Frank Vogl, *Waging War on Corruption: Inside the Movement Fighting The Abuse of Power* 213 (2012).

<sup>1552</sup> See *ibid.* at 216; see, e.g., Hearing before the Comm. on Foreign Relations, *supra* note 2, at 2 (“The ‘pressure to lend’ creates a bias in favor of quantitative rather than qualitative results, and corrupt elements in client governments know this.”) (statement by Professor Jeffrey A. Winters).

<sup>1553</sup> Int’l Bank for Reconstruction and Dev., General Conditions for Loans, at §§ 3.02(a), 7.06(a) (Mar. 12, 2012) available at [http://siteresources.worldbank.org/INTLAWJUSTICE/Resources/IBRD\\_GC\\_English\\_12.pdf](http://siteresources.worldbank.org/INTLAWJUSTICE/Resources/IBRD_GC_English_12.pdf).

<sup>1554</sup> Vogl, *supra* note 1551, at 214 (highlighting that the World Bank “has often been more a part of the problem than a contributor to the solution”); *Combating Corruption in the Multilateral Development Banks: Hearing before the Comm. on Foreign Relations, 108th Cong., 2d Sess. 6 (2004)* [hereinafter *Hearing before the Comm. on Foreign Relations*] (statement by Professor Jeffrey A. Winters, Professor of Political Sci., Northwestern Univ.) (“Under international law, the Articles of Agreement explicitly require the World Bank to make arrangements to ensure that the funds it lends or guarantees are used for their intended purpose. For decades it did not do this, despite extensive knowledge that loan funds were being systematically stolen.”); Iberto Alesina & Beatrice Weder, *Do Corrupt Governments Receive Less Foreign Aid?* 5 (Nat’l Bureau of Econ. Research, Working Paper No. 7108, 1999), available at <http://www.nber.org/papers/w7108.pdf> (arguing that developmental loans often aid in increasing corruption).

funds, should “have the ... responsibility to follow the money and to ensure that the money serves the purposes for which it is disbursed.”<sup>1555</sup>

Lack of due diligence has converted the World Bank into a passive participant to the corrupt and illicit flow of cash.<sup>1556</sup> The lending practices of the Bank create a systemic risk within the financial sector, along with the anticorruption regime:

[T]he major governments have come to appreciate that illicit financial flows are on such a scale that they threaten the stability of the global financial system and that, as a result, there are profound systemic reasons ... for a larger assault on all those institutions ... that support the global money-laundering business.<sup>1557</sup>

Even more so, there are those who believe “there is bound to come a time when a [U.S.] congressional committee investigates the World Bank's anticorruption record and finds that the World Bank's continued trust in governments that are highly corrupt has led to the waste of vast amounts of cash.”<sup>1558</sup> The way loans are handled goes beyond a breach of the Bank's fiduciary duties, the loans can be seen as criminal in two senses--first because it [is] a crime to allow the development funds to be stolen, and second because it is an injustice to expect poor populations ... that never received these funds to ... repay 100% of the loans plus interest.”<sup>1559</sup>

In addition to the lack of due diligence when it comes to funds, it can be argued that when the Bank does in fact engage in anticorruption sanction procedures, it is going after the wrong offender. The Bank targets suppliers on government contracts, but the question

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<sup>1555</sup> Paul A. Volcker et al., Independent Panel Review of the World Bank Group: Department of Institutional Integrity 10 (2007), available at [http://siteresources.worldbank.org/NEWS/Resources/Volcker\\_Report\\_Sept\\_12\\_for\\_website\\_FINAL.pdf](http://siteresources.worldbank.org/NEWS/Resources/Volcker_Report_Sept_12_for_website_FINAL.pdf). The panel also noted that “[a] lack of common purpose, distrust, and uncertainty has enveloped the anti-corruption work of the Bank.” Id. at 9. But see Transparency International, Press Release, Hugette Labelle, Chair of Transparency International (June 26, 2014) (“the World Bank's sanction process is critical to eradicate fraud, corruption and collusion from the projects it finances.”)

<sup>1556</sup> Vogl, *supra* note 1551, at 234.

<sup>1557</sup> *Ibid.*

<sup>1558</sup> *Ibid.*

<sup>1559</sup> Hearing before the Comm. on Foreign Relations, *supra* note 1552, at 1 (adding that the World Bank has a “‘don't ask, don't tell’ policy regarding criminal debt”).

is whether these private actors are really the most responsible in the scheme of corrupt practices, or should the target actually be the local government and law enforcement. There are obvious setbacks that would make it difficult to switch the anticorruption regime to focus on the corrupt governments themselves. First, government officials, when involved in a crime, are likely to prevent any investigation that would jeopardize their position and put their assets at risk.<sup>1560</sup> Yet, the likelihood of encountering an influential government official is not the not great.<sup>1561</sup> The Bank, however, acts as if it cannot rely on the local law enforcement in general; instead it conducts its own initiatives in all cases of alleged violations. Nonetheless, when looking at the primary goal of safeguarding development funds, it seems inconsistent to hold suppliers responsible and not focus on the governments that are put in charge of distributing the funds appropriately and efficiently. It cannot be argued that funds are more protected by holding only suppliers accountable when decisions about the proceeds come from the government representatives. By only looking to suppliers, government representatives can simply turn to another supplier when one is debarred from the procurement process.

The issue with a sanctions regime is that it is supplier-focused in its fight against corruption and it is the doubt attitude toward corruption among suppliers that does not automatically prevent government representatives from conducting bribes. In fact, the profit the can be obtained for those involved and bribes for the corrupt decision makers may even rise if suppliers are debarred from a certain market.<sup>1562</sup> Also, given local law enforcement is not as robust, and even with the MDBs sanctions regime, the chance of being cause in corruption remains low. Thus, regardless of any deterrent effects the sanctions regime may invoke, corrupt governments may continue to have a steady supply of entities willing to partake in corrupt deals.<sup>1563</sup> In the end, a decline in the number of firms willing to offer bribes may simply imply greater paybacks for those firms that are still involved in corrupt schemes, and the problem is not really addressed if the regime only

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<sup>1560</sup> Soreide, *supra* note 1463, at 11.

<sup>1561</sup> *Ibid.* (finding that more often the perpetrators are not influential enough to prevent an investigation).

<sup>1562</sup> For an explanation of how bribes depend on shifts in the supply and demand functions, see Susan Rose-Ackerman, *Corruption: A Study in Political Economy* Academic Press, (1978).

<sup>1563</sup> Soreide, *supra* note 1463, at 13.

looks to the suppliers.<sup>1564</sup> The regime cannot be seen as efficient in diminishing corruption if government representatives cannot be reached. To that end, it can seem that the MDBs sanctions regime targets the wrong offenders, or at least does not target all the offenders necessary to truly prevent corruption of funds.

Regardless, MDBs should keep funding projects even in countries with high level of corruption, since the poorest people in the world are often the ones that live in those countries where corruption is indeed a serious issue for the whole society. In doing so, measures such as country assistance programs should try to be implemented. Such programs can focus on governance and anticorruption problems as a means to ensure the recipient country's compliance with anticorruption protocols. A monitoring mechanism could also aid to ensure that the funds are in fact being used for the purposes they were intended for. Remedial measures could also go hand-in-hand in the case misallocation or abuse of funds is found to have occurred.

Despite the inherent weakness of domestic regimes, it is critical for them to gain trust in their respective societies so as to be able to function properly. The World Bank cannot trust organizations that are not reliable. Yet, by refusing to trust any domestic courts – and announcing that they are not to be trusted – the Bank's sanctions regime underlines a public belief that domestic institutions lack the capacity to enforce the laws of their countries. In doing so, the Bank aids in pushing both private parties and public officials toward alternative and informal strategies, such as bribery and corruption, to handle their issues.<sup>1565</sup> It is this behavior that undermines the very issue that the sanctions regime is to combat. The MDBs must understand that there is a need to collaborate with local enforcement in order to achieve their goals. Although internal procedures should incorporate more due diligence, the organizations should also pursue alternative outlets for demanding systems with working integrity in countries where its funds go to support development projects. Currently, when an offence has been committed, INT does work

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<sup>1564</sup> For an analysis of the market consequences of competition between firms encountering sanctions as a consequence of uncovered corruption see Kjetil Bjorvatn and Tina Søreide. *Corruption and Competition for Natural Resources*, 21(6). *Int'l Tax & Pub. Fin.* 997-1011 (2014)

<sup>1565</sup> Søreide, *supra* note 1463.



with law enforcement institutions on a national level. In its collaboration, INT encourages the national institutions to investigate and prosecute those involved in offences and may be out of reach for the World Bank, which may include government officials. INT representatives could potentially extend this collaboration by serving as advisers during cases. The effort would create a stronger force against corruption in aiding the local governments to act independently and honestly, and protect the funds as they are supposed.

## **Conclusion**

The International Monetary Fund and the World Bank play a critical role in promoting stability and combating financial crimes. Despite the criticisms these international financial institutions receive, the world is dependent on them for their resources, expertise, and capacity to address the issues of global financial crimes. It is not enough for countries to be isolated in their means to combat these crimes. A transnational world where crimes are committed in various areas that transcend borders requires greater tools in order to maintain safety and stability of the world market. Accordingly, this foregoing review of the literature creates huge responsibility for the IFIs in combating financial crimes and promoting stability. In this means, the IFIs can turn to mechanisms not currently used as policy tools, such as conditions, in order to ensure countries are implementing international standards against financial crimes. Additionally, the IFIs should turn to tools already in use to continue their goals but to expand their use or better them in order to accomplish the aims they have sought out to achieve.

The MDBs have a challenging mandate – they must provide financial support to developing countries, particularly with regard to those with rampant corruption, while at the same time attempting to safeguard the efficient use of those funds when they are no longer in control by the MDBs. The sanctions regime is a great step towards fighting corruption. It must be examined with regard to the MDBs' need to maintain confidence in donor government and also offer financial aid to those countries that are unable to fight fraud and corruption on their own. As a strategy to handle their obligations, the MDBs have harmonized on the sanctions regime, focusing on suppliers of government contracts while

providing a quasi-judicial system with due process measures to respect the rights of those involved. However, the efficiency and overall goals the MDBs wish to achieve require a hard look into how this system is actually attacking the problem of corruption. Greater internal measures along with transparency are needed to ensure due diligence and that the MDBs are doing their part, not just on the sanctions side. More can be done, implemented and harmonized in order to further the fight against corruption. It was noted that the World Bank Legal Vice Presidency, which oversees the sanctions system, has demonstrated attention in comprehending the root causes of corruption in order to better assess the Bank's anticorruption initiatives. An exhaustive review of the system, taking into consideration all sides, is likely to disclose that the current design of the sanctions regime is not founded upon an understanding of essential causes of corruption, and that the calls for debates about the regime's functionality are warranted.

The MDBs must be aware that they cannot bypass local governments when it comes to corruption. It is as if they are condoning turning a blind eye to the matter knowing that continuously, year by year, funds are taken for corrupt ends. Rather than focusing sanction efforts only on suppliers, which has its drawbacks as was discussed above, the MDBs can harmonize their efforts and sanction governments that fail to investigate and prosecute government officials who are guilty of corruption, along with the suppliers. Collaboration efforts between the MDBs and the local officials may be needed due to the lack of structure and trust in the systems, however, the results would send a strong message of the seriousness and determination to end corruption. The MDBs could also implement the notion of "ex post conditionality" on governance by rewarding good performance with greater financial support or greater freedom in spending.<sup>1566</sup> Third party monitors could also be employed to manage funds to ensure their allocation adheres to their intended purposes.<sup>1567</sup> While these options may seem difficult or beyond the scope of a mandate, it is important to recall that the World Bank, in embarking on its role into corruption, realized

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<sup>1566</sup> Paul Collier, Learning from Failure: The International Financial Institutions as Agencies of Restraint in Africa, in *The Self-Restraining State: Power and Accountability in New Democracies* 313–32 (Andreas Schedler et al. eds., 1999).

<sup>1567</sup> Eirik G. Jansen, "Don't Rock the Boat": Norway's Difficulties in Dealing with Corruption in Development Aid, in *Corruption, Grabbing and Development: Real World Challenges* 186–95 (Tina Søreide & Aled Williams eds., 2014).

the need to look deeper into its mandate and that corruption is not just a political concern. It is indeed a cancer that can continue to harm those that are most vulnerable in the world. Local judicial and law enforcement institutions must be monitored, as well as the funds. They must build trust and serve their intended purposes if there is truly to be a solution to corruption.

## CHAPTER 9

### CONCLUSION

#### Introduction

In evaluating the role of the International Financial Institutions in promoting stability and examining the various financial crimes that are rampant in the financial system, along with the mechanisms in place in trying to combat them, there are some general issues that need to be addressed in order to ensure financial stability.<sup>1568</sup> Primarily, regulatory, reforms and enforcement issues continue to need to be revised and re-examined.

#### **More regulation and supervision is needed for financial stability**

The objectives of financial regulation determine the environment of the financial system.<sup>1569</sup> It is understandable that financial regulators have a tough job to complete. The process of regulation is multifaceted and involves deliberation of conflicting goals, interests of various entities such as governments, financial regulators, regulated institutions and their clients, and all these stakeholders that do not have the same priorities.<sup>1570</sup> However, the primary goals that should be in forefront of regulators are: achieving and maintaining financial system stability and confidence in the financial system (goal set at a macro level), providing a safe and sound operation of financial intermediaries (goal set at micro level) and the protection of users of financial services.

Currently, the global market has created an effect of “regulatory arbitrage” allowing financial institutions to choose the financial system and the regulatory regime that suits their needs the best.<sup>1571</sup> Being able to choose of course creates competition among financial

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<sup>1568</sup> Global Economic Stability Report Potent Policies for Successful Normalization, xiii (Int'l Monetary Fund, April 2016) available at [https://www.imf.org/External/Pubs/FT/GFSR/2016/01/pdf/text\\_v2.pdf](https://www.imf.org/External/Pubs/FT/GFSR/2016/01/pdf/text_v2.pdf) (finding that overall stability risks have increased since 2015).

<sup>1569</sup> Ajan V. Thakor, The design of financial systems: An overview, 20 J. OF BANKING AND FINANCE 917, 917-918 (1996).

<sup>1570</sup> Carol Sergeant, Risk-based regulation in the Financial Services Authority, 10:4 Journal of Financial Regulation and Compliance 329, 330 (2002).

<sup>1571</sup> Gerald Hertig, Regulatory competition for EU financial services, 2 Journal of International Economic Law, 349, 365 (2000).

regulators and can encourage innovations and strengthen the role of market mechanism. However, it also leads to competitive de-regulation, weakening the control and causing reluctance to implement appropriate sound measures.<sup>1572</sup> As a means to combat this laxity and competitive deregulation, international financial institutions have stepped up to set standards and principals that are supposed to be met throughout the global market. Nevertheless, there is still a decentralized system for financial regulation, although there is more of an effort for countries to provide a united front with common goals of financial stability.

The lacking of a central regulator may be the issue that is preventing the global market from fully achieving financial stability and soundness and gaining the confidence that goes along with these goals. As it has been discussed, financial crimes have an even more global aspect to them. Money laundering techniques have turned into terrorist financing activities, cyber-crimes are present as our world becomes more connected, and insider dealing is alive and well throughout the international markets. Moreover, the lack of uniform definitions means that countries are simply able to define and regulate as they see fit. This prevents international unity and means that one person may be able to escape scrutiny under one definition while another may not.

The role of International financial institutions mainly the World Bank and the International Monetary Fund (IMF) in promoting stability by combating fraud and insider dealing, has been examined in the second chapter which concluded that, neither the United States nor the United Kingdom provides perfect examples of insider dealing regulation, The U.S. has become a model for many other countries in developing their laws and enforcement regimes against insider dealing, considering the U.S. has the most prosecutions for the crime.<sup>1573</sup> However, the U.S. regime has also been argued to be “inconsistent and erratic . . . regulation that ill serves the investing public.”<sup>1574</sup> This in turn

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<sup>1572</sup> Caroline Bradley, *Competitive deregulation of financial services activity in Europe after 1992*, 11 *Oxford Journal of Legal Studies* 545, 554-556 (1997).

<sup>1573</sup> *Ibid.*

<sup>1574</sup> Marc I. Steinberg, *Insider Trading – A Comparative Perspective*, IMF 1, 16 (2002), available at <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/steinb.pdf> (observing that while the United States

can seem as though the United States' laws are not sufficient to protect investors and market integrity like other markets.<sup>1575</sup> Nevertheless, the crucial factor is enforcement of its laws. While other countries may have wider nets that encompass greater factors for insider dealing, the United States is the country that manages to enforce the most, providing remedies for the breaches. Statutes and insider dealing regimes will only ever be as effective as they can be enforced regularly and bring results.

However, much like any other regulatory body that needs to cover and monitor numerous institutions, a network could be implemented in order to carry out the regulator's mandate. The important aspect would be common definitions, sanctions, and other aspects of the regulatory system. Further reform of the financial system would require a global, integrated approach, not only in terms of harmonization of the rules on banks, but also harmonization of supervision. In turn, this would aid tremendously in financial system stability and combat financial crimes that diminish confidence and economic efficiency.

### **Formulation of sound practices**

Given that there is no super-international regulatory body, and no plan of one occurring in the near future, the international community must come together to fully support a consensus on sound macroeconomic and structural policies. These policies of course will fall on national governments to ensure proper implementation and to absorb the risks involved when they fail to do so. The International Monetary Fund already has crafted indicators for measuring financial stability, but more needs to be done regarding practices and principles in a regulatory scheme.<sup>1576</sup> Without more of a focus on sound policies, market chaos may occur, financial conditions will tighten thereby erode confidence. International and national policymakers must work together to develop a more resilient path for growth and stability, while finding a means to protect the market from the devastating effects of financial crimes.

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has strong enforcement of their insider trading laws, the laws are still not the most effective and concise application).

<sup>1575</sup> Ibid. at 26.

<sup>1576</sup> Int'l Monetary Fund, Financial Soundness Indicators, <http://data.imf.org/?sk=9F855EAE-C765-405E-9C9A-A9DC2C1FEE47>.

In coming to an agreement on strict policies and practices, not simply recommendation, governments can be depended on provide stable environments to encourage economic growth and combat financial crimes. However, international financial institutions would still have an integral role in creating and enhancing financial stability as examined in chapter 8. The IFIs should support and encourage the implementation of best practices throughout the global market. They can assist in national efforts to minimize the macroeconomic inequities and eradicate the structural distortions that are at the root of financial instability. Moreover, by encouraging the improvement of the quality and comparability of the information that is currently made available, and encouraging and supporting additional dissemination of data, they can improve the capacity of stakeholders to monitor progress and provide the incentives and discipline that will bolster the robustness of financial systems.

### **Better data on financial crimes is needed in order to promote financial stability**

Regulatory measures even if not done by international regulatory body, can and should aid in increasing information and implement requirements to provide more information on financial crimes regularly. Asymmetrical information creates a moral hazard when it comes to financial crimes and governments should be incentivized to try and reduce this problem. Accordingly, laws should be enforced to compel firms to maintain internal controls that help to supervise and monitor their conduct. Monitoring provides a means to engage in information production through audits to strengthen and certify what is going on. Solving the lack of information would help improve results for stability and soundness, providing better measurement of criminal activity and suspicious activity, and also providing insight into the costs and benefits. When more information is gathered, regulations and monitoring can be adjusted to catch the criminals and also increase the costs of the crime, ensuring a greater likelihood of penalties being incurred.

Financial crimes involve a spectrum of activities and financial instruments which are difficult to detect making meaningful estimates and difficult to collect. The gravity of these crimes requires more and better data. Although macroeconomic data can provide suggestions of both direct and indirect influences on financial crimes, the addition of indirect influences creates doubt as to what exactly is being measured. Conversely, a micro-based approach necessitates the creation of copious amounts of data primarily for measurement purposes. As such, measures of this data need to be taken as much as possible on both macro and micro levels in order to gain critical information to bulk up regulatory measures.

**Risk-based approach could be taken to tackle financial crimes as a means to promote financial stability**

Supervisors should adopt a risk-based approach to supervising the financial industry's risk management. This kind of approach requires that supervisors: i) gain a comprehensive understanding of the risks that exist in the jurisdiction and their potential impact on the supervised entities; ii) assess the sufficiency of the system's risk assessment based on the jurisdiction's national risk assessment; iii) evaluate the risks present in the target supervised entity to understand the nature and extent of the risks in the entity's customer base, products and services and the geographical locations in which the bank and its customers do business; iv) evaluate the adequacy and effectiveness in implementation of the controls designed in achieving obligations and risk mitigation; and v) utilize this information to allocate the resources, scope the review, identify the necessary supervisory expertise and experience needed to conduct an effective review and allocate these resources relative to the identified risks. Supervisors have a duty to ensure their banks maintain sound financial crime risk management to protect their own safety and soundness and also to protect the integrity of the financial system as a whole.<sup>1577</sup>

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<sup>1577</sup> BIS. Sound management of risks related to money laundering and financing of terrorism. Basel Committee on Banking Supervision - Consultative Document. June 2013. Available at <http://www.bis.org/publ/bcbs252.pdf>.



The risk-based approach system is a method that can help rank supervision activities, adopted by regulatory agencies in various countries, and intended to encourage an efficient relationship between the use of available resources and materials with the accomplishment of goals enacted. As a result, the system is composed of the following stages: (i) identifying the risks to which the market at hand is exposed; (ii) sizing such risks and sorting them according to potential damage levels; (iii) deciding how to mitigate the risks found and sized; and (iv) controlling and monitoring risk events. The risk-based approach's main characterization is to sort out the risks found. The risks are separated depending on their likelihood of occurring, and according to the potential impact caused in the event they do occur.<sup>1578</sup> This approach is suggested as a means to increase the effectiveness of information provided by financial institutions. This method can also help promote efficiency in supervisors by guaranteeing institutional procedures and controls are reliable and appropriate to their risk levels.<sup>1579</sup> Financial system stability is critical to both national and international economic efficiency. Financial crimes can implicate the soundness of the financial system and increase the volatility of capital flows, creating wide inefficiencies. Financial crimes can take many forms, but their reach is growing every year, spanning the globe and causing effects throughout the markets. This wide reach of financial crimes also causes alterations in how resources can be used and how wealth gets distributed. These effects are clearly hard and costly to detect and prevent, but more efforts must be taken to get a better handle on these issues.

Financial crimes are far from being victimless crimes. These crimes jeopardize the integrity of financial institutions while criminals seek to increase their illegal profits to enjoy that “champagne lifestyle”<sup>1580</sup> or to carry out atrocities for terrorist aims.<sup>1581</sup> The crimes discussed herein significantly weaken the financial systems, which are primary

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<sup>1578</sup> Mauro Salvo, *Money Laundering as a Threat to Financial Stability: a risk-based approach* 16 (2014).

<sup>1579</sup> *Ibid.*

<sup>1580</sup> N. Ryder, *Financial Crime in the 21<sup>st</sup> Century*, (Ed. Edward Elgar 2011).

<sup>1581</sup> Jimmy Gurulé, *Unfunding Terror: The Legal Response to the Financing of Global Terrorism* 3 (2008); Nat'l Comm'n on Terrorist Attacks upon the U.S., *THE 9/11 COMMISSION REPORT* 169-72 (2004) [hereinafter *9/11 COMMISSION REPORT*], available at <http://www.9-11commission.gov/report/911Report.pdf>; see also Nick Ridley, *Terrorist Financing: The Failure of Counter Measures 1-2* (2012) (“[E]fforts against terrorist financing tend to be focused on assessing and calculating individual operational costs, and the significance of auxiliary support or infrastructure is not yet fully apparent to organizations and agencies engaged in counter terrorism”).

players in the global markets when it comes to transactions as well as dictating the welfare of the global economy.<sup>1582</sup> Financial instability resulting from financial crimes can also lead to national security issues given that these criminals are breaching laws and continuing to get away with their illicit aims.<sup>1583</sup> To this end, the International Monetary Fund has even recognized that financial abuse:

“...could compromise bank soundness with potentially large fiscal liabilities, lessen the ability to attract foreign investment, and increase volatility of international capital flows and exchange rates...financial system abuse, financial crime, and money laundering may also distort the allocation of resources and the distribution of wealth.”<sup>1584</sup>

Financial crimes also have individual affects. Although these effect on individuals are much less then public and private sector losses, they nevertheless have a great effect on the individuals affected. Individuals can result in lessening the flow of funds in the financial system due to distrust and a lack of confidence. Naturally, a decrease in funds from individuals can add up when several feel the effects of financial crimes. The impact of financial crimes cannot be overstated. The measurement of these financial crimes is far from concrete. The figures cited by various institutions may or may not be just the tip of the iceberg. Accordingly, it is of the utmost importance that national and international regulatory systems, legislation, and standards that are in place effectively work to combat the commission of these crimes. This thesis has argued that greater regulation is needed rather than deregulation. Although many may feel regulations hinder financial competition, there are certain aims which must take priority. Financial stability is interconnected with some many aspects of national and international economic aspects. When financial crimes are continuously committed and a grasp cannot be had on them, this creates significant

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<sup>1582</sup> S. Vaithilingham & M. Nair, Factors affecting Money Laundering: Lesson for developing countries, 10(3) J. of Money Laundering Control 352 (2008).

<sup>1583</sup> Ryder, *supra* note 1580.

<sup>1584</sup> See International Monetary Fund, Financial System Abuse, Financial Crime and Money Laundering – Background Paper, (Int’l Monetary Fund, 12 Feb. 2001).

instability which can hinder growth and diminish confidence, and as it has been noted, this has poor effects, both on the macro and micro level.

More international cooperation would also aid in hindering financial crimes. Currently there are many institutions that function to supervise, monitor and conduct assessments of financial stability. However, many of these organizations lack the rule of law to enforce their standards. Additionally, national governments can simply take the principles and standards to shape them to fit their financial system. The lack of cohesion and legal requirement creates little ability to formally enforce the rule of law across the board. Various definitions for the same financial crime have been created in different jurisdictions, leaving countries on uneven grounds for fighting them. This presents a problem for financial stability given that financial crimes are not being fought as a united force by the international community and also because of the risk of spill over from jurisdictions with weaker legal systems. More data could also be required in order to more efficiently ward off financial crimes. Measures on how and what these crimes actually entail and hammering down more on what needs to be addressed would obviously ramp their efforts. The international financial institutions, which already carry out these types of measures and indicators, could begin applying more options to gather relevant data to aid in this process. Producing more sound practices and policies will ensure stability. Tips from Islamic banking could also aid in this in how they handle their financial system and the moral obligations behind the function they have. Although it has been seen that Islamic banking may not be the ideal alternative, it is more resilient to financial crimes and financial crises. More data on how certain aspects can be implemented into conventional financial system may strengthen.

Resilient financial systems that are well regulated and well-supervised are essential for both domestic and international economic and financial stability. This is not an easy task and it takes efforts from all fronts of the problem. The goal to improve the financial system is an essential tool for global economic development. This can only be achieved with the help of all financial institutions, the government and citizens to ensure the system is not used or susceptible to financial crimes or harmful to competition, so as not to

deteriorate healthy financial relationships. Policy makers need to understand that financial stability and competition are not mutually exclusive. Both can be achieved when working as primary aims. However, financial crimes, in using illegal resources to infiltrate the financial system can destabilize domestic and international economy and their impacts may cross borders, given the global economy's interdependent character. Accordingly, more research needs to be done and greater efforts to try to make stronger, cohesive and far reaching regulations and policies must be undertaken.

An important related initiative concerns the work of the IMF and the World Bank to encourage compliance with international standards and codes in the financial sector. As part of a broader initiative, the fund and the Bank have adopted several standards and codes that specify good practices that countries should observe in designing and implementing the institutional framework governing different aspects of the financial sector. While some of these standards were developed by the IMF and the World Bank, many others were developed by other international bodies with expertise in particular areas, including the Basel Committee's Core Principles on Banking Supervision, the International Organization of Securities Commission's objectives for Securities Regulations, the International Association of Insurance Supervisors' Insurance Supervisory Principles, the Committee on Payments and Settlement Systems, and financial Action Task Force's Recommendations on in the area of Anti-money Laundering and Combating the Financing Terrorism. Other standards address such issues as the conduct of monetary and financial policy, corporate governance, accounting and auditing.

The IMF and The World Bank assess members' compliance with these standards and issue reports on their observance known as Reports on Observance of Standards and Codes or "ROSCs," The purpose of the ROSC exercise is to identify in a member's institutional framework areas that need to be strengthened. As has been argued on Chapter 6 that the risk to financial institutions of non-compliance with AML laws and regulations and reporting requirements currently appear to outweigh any risks of civil liability. Global oversight has become an imperative to reduce the conflicts of interest that may

create profitable industries but not socially beneficial ones. Leaders of the world and organizations such as Basel Committee and FATF must work together to make mutually reinforcing structure in order to move into a compliance order that is taken seriously and yields the results needed. FATCA, just one example of this new world of regulatory compliance obligation, is already imposing extraordinary administrative burdens on US institutions and foreign government and has been resulted on closing of accounts and the withdrawal of assets. These business challenges are foreseeable consequences of a new environment of openness made possible by technological capabilities and fueled by the fight against money laundering, terrorist financing and sanctions regimes and determination of the US to recoup the enormous revenues lost to tax evasion.<sup>1585</sup> Therefore, as established on Chapter 6 the culture of compliance is significantly promoting financial stability and shield financial institutions from potential misconduct.

Chapter 3 concluded that although difficult to measure, the magnitude of the sums involved and the extent of criminal activities that generate criminal income have implications for both the domestic and the international allocation of resources and microeconomic stability. Although, the IMF reports, there is currently no theoretical literature on the microeconomic effects of money laundering, indirect macro-based empirical research and related studies of crime and the underground economy, coupled with the pervasive role of money laundering in illegal activity, suggest that money laundering maybe sufficiently widespread to exert an independent impact on the macro economy.<sup>1586</sup> Another contested issue in the ‘balancing act’ between the money laundering and financing terrorism counter measures and the legal principles mainly the human rights has concluded that all relevant international initiatives have justified action against money laundering order to deprive perpetrators of serious offences (organized crime, terrorism) from their proceeds.

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<sup>1585</sup> International Financial Crimes Research Handbook, Edited by: Barry Rider p.515. (Edward Elgar Publishing Limited 2015)

<sup>1586</sup> Commission of European Communities, Second Commission Report to the European Parliament and the Council on the implementation of the Money Laundering Directive, COM (1998) final Brussels 1.7.1998 p. 18.

Chapter 6 of this thesis established that the performance and growth of Islamic finance are backed by number of support from multilateral organizations and governments of developing countries, developing countries' engagement with Islamic finance. While useful for its ethical underpinnings, the provision of alternative sources of funding, contribution to the global financial system, political inclusion, and an adequacy for public infrastructure projects found in Islamic banking presents significant challenges. As institutions inexperienced with Islamic finance look to the industry funding, they will face practical obstacles in acquiring expertise in the field as well as political challenges in quelling tainted perceptions of Islam in the current political economy. These present obstacles that have to be resolved with political will, institutional strength, and regulatory oversight for which non-Muslim developing countries without sufficient resources might be inadequately prepared. Furthermore, the research established that the performance of capital markets, the weekly returns on Islamic Equities portfolio (Sharia) outpace the portfolios of the overall European market and market without financial forms. However, when an economy experiences an upward growth trend, Sharia-compliant equities slightly underperform the market portfolio. Events show from 2007-2008 financial crisis suggests that the factors related to Islamic banks' business model helped contain the adverse impact on profitability in 2008, while weaknesses in risk management practices in some Islamic banks led to larger decline in profitability compared to commercial banks in 2009. In particular, adherence to Shariah principles precluded Islamic banks from financing or investing on the kind of instruments that have adversely affected their conventional competitors and triggered the global financial crisis.<sup>1587</sup> Thus far demonstrates that the financial crisis tested the resilience of Islamic finance, which lacks the risk frameworks of conventional banking for faster recovery. While Islamic Financial Institutions do appear to be slightly more resilient than conventional institutions, the delayed collapse of Dubai's real estate market further exemplifies the fact that IFIs and the societies in which they operate are inextricably linked to the majority non-Islamic financial sector.

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<sup>1587</sup> Maher Hassan & Jemma Dridi, The effects of Global Crisis on Islamic and conventional Banks. A Comparative Study. IMF working paper 2011.

The IMF and the World Bank's role in promoting stability throughout their sanction regimes were discussed in chapter 8. This chapter explained that IFIs can turn to mechanisms not currently used as policy tools, such as conditions, in order to ensure countries are implementing international standards against financial crimes. Additionally, the IFIs should turn to tools already in use to continue their goals but to expand their use or better them in order to accomplish the aims they have sought out to achieve. The MDBs have a challenging mandate – they must provide financial support to developing countries, particularly with regard to those with rampant corruption, while at the same time attempting to safeguard the efficient use of those funds when they are no longer in control by the MDBs. The sanctions regime is a great step towards fighting corruption. It must be examined with regard to the MDBs' need to maintain confidence in donor government and also offer financial aid to those countries that are unable to fight fraud and corruption on their own. As a strategy to handle their obligations, the MDBs have harmonized on the sanctions regime, focusing on suppliers of government contracts while providing a quasi-judicial system with due process measures to respect the rights of those involved. However, the efficiency and overall goals the MDBs wish to achieve require a hard look into how this system is actually attacking the problem of corruption. Greater internal measures along with transparency are needed to ensure due diligence and that the MDBs are doing their part, not just on the sanctions side. More can be done, implemented and harmonized in order to further the fight against corruption. It was noted that the World Bank Legal Vice Presidency, which oversees the sanctions system, has demonstrated attention in comprehending the root causes of corruption in order to better assess the Bank's anticorruption initiatives. An exhaustive review of the system, taking into consideration all sides, is likely to disclose that the current design of the sanctions regime is not founded upon an understanding of essential causes of corruption, and that the calls for debates about the regime's functionality are warranted.

Finally, it is clear that at the cornerstone of our risk-based approach is the idea that we should focus our and industry's resources where they will have most effect. No regulator will end money laundering, fraud, cybercrime or insider dealing overnight. But effective anti-financial crime systems and controls in financial institutions can make it significantly harder for criminals to access the financial system, so there's value working with IFIs to focus their efforts, by sharing assessment of the threats. I *also* believe the results will make us better at allocating our own resources, so regulation has a greater effect on tackling financial crime and promote stability.

This research has also engaged in critical analysis for financial crimes, identifying what market and other mechanisms International financial institutions can play, realistically use to bring about a reduction in financial crime. If successful at this first stage, we expect to continue the project, developing concepts of measurement and their application so we can assess the scale and impact of financial crime using robust techniques.

Financial criminal policy making should be evidence-based. A key to delivering this is the unique skills and viewpoint of the academic community, which is why we have sought to engage with them on this project. The key to delivering market stability in the face of increasing financial crime is an understanding of the risks, and transparent communication of these risks. The risk-based approach requires continual review, communication and information sharing between and within the public and private sectors. Academic work to improve the means of measurement means better and more targeted action. That, in turn, will lead to more stable markets.



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