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ILLICIT FINANCE AND NATIONAL SECURITY

Authoritarian Influence in a Financially Globalized World

The volume and complexity of cross-border capital flows is a relatively new, post-Bretton Woods phenomenon. And while the use of economic and financial influence to pursue geopolitical ends is certainly not novel, the rise of authoritarian actors who understand how to harness such operations in an environment of financial globalization is more recent still. For this reason, analysts tend to commit a category error when assessing the effectiveness of Western anti-money laundering (AML) and financial transparency measures.

Yes, the European and American AML regimes are less efficient and effective than they should be. But not because, as the truism has it, most money launderers are not prosecuted, most corruption proceeds are not seized, and most suspicious activity reports are not read. The U.S. and EU regulatory regimes are not fit for purpose precisely because they are designed to support criminal law enforcement investigations. The key analytical insight that will produce a more effective approach is to stop thinking of the problem as one of AML and start thinking of money laundering as a subset of illicit finance. Illicit finance encompasses a range of financial activity facilitating everything from organized crime and public corruption to weapons proliferation, terrorism, active measures or interference operations, and strategic economic influence campaigns.

Softer security threats are no less pressing because they are often harder to attribute, harder to identify, and harder to quantify. The export of corrupt business practices may or may not be strategic or top-down. But the unjustified enrichment of domestic elites absolutely poses a security risk when it creates a constituency indebted to an authoritarian government… or, more fiendishly ambiguous still, a constituency indebted to a company or businessperson that may or may not be acting to further the interests of an authoritarian government. Acquisitions in key technology sectors by investors from authoritarian countries may have purely commercial motivations. They may also be designed to steal technology or intellectual property or to gain

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access to sensitive user data. Or they may be something in between.

The implications of this analysis for policies designed to counter illicit finance, particularly activity emanating from authoritarian countries and entering the Western financial system via cross-border flows, are threefold: we need better supervision, better information, and a change in mentality.

Better Supervision

Both the Europe and the United States must update their supervisory frameworks, which are out of date. The EU has created a single market for financial services and, inside it, a common currency area with centralized prudential supervision, while relegating AML (or, better, counter-illicit finance) duties to national supervisors. This arrangement inevitably introduces coordination problems and creates resource mismatches in small jurisdictions with outsized financial sectors. It can also feed a vicious circle in which weak enforcement breeds a sector, or elements of a sector, dependent on dirty or opaque money, which in turn makes it politically more difficult to tackle the problem. Overall, penalties for violations have been modest.

In the United States, by contrast, banking supervision is strong, with large, dissuasive fines for AML violations. Enforcement drops off, though, for non-bank institutions, including securities firms, payments companies, and private investment funds, the last of which are exempt from AML requirements. The EU has imposed AML requirements on these funds for a number of years, although there have not yet been any major enforcement cases.

Better Information

The EU and the U.S. allow largely unrestricted financial flows and foreign investment but fail to track the money with systematic rigor. An effective effort to counter illicit financial activity that poses a security risk will rely as much on high-quality data and comprehensive information as on supervision and enforcement. Examining the main forms of foreign investment one by one, it is apparent that none is particularly well-monitored.

Portfolio investment in publicly traded stocks and bonds is the single largest category. Governments know far less about who owns these securities than one might assume. In the U.S., for example, equity ownership is reportable at a five percent threshold, but there is not an equivalent requirement for bonds, including U.S. Treasuries, i.e. sovereign debt. Just as important, both domestic and cross-border securities trades in the U.S. and Europe can be layered through multiple actors, so that the underlying client is often unknown to the parties involved. This opacity is standard practice for stock and bond trading but is considered unacceptable for domestic or international funds transfers.

Ownership of non-publicly traded companies is even less transparent. Foreign direct investment (FDI) surveys face multiple challenges, including the channeling of investment through offshore shell companies, often for tax minimization purposes. The biggest issue, though, is that governments are unequipped to track investment routed through private equity or venture capital funds. FDI surveys do not see through these funds to their underlying investors. The solution is a separate reporting stream piped directly and confidentially to funds' supervisors or to the financial intelligence unit, which collects suspicious activity and other transactional reports. These reporting streams should list the identities of funds' investors at the beneficial ownership level and the assets held by the funds. They should be updated on a reasonably frequent basis. Access to this information would help policymakers in a number of ways, not least by improving foreign investment screening.

Foreign investment screening itself is another key tool in the toolkit. The Committee on Foreign Investment in the United States was recently strengthened by new legislation and is quite robust. The two outstanding question marks are the committee's inability to review greenfield projects and uncertainty about its treatment of the aforementioned private investment fund with foreign limited partners. In Europe, the action is still very much at the national level, although the EU has recently created a non-binding, advisory review mechanism. Screening varies widely by member state but is moving in the right direction.

Anonymity in real estate, another significant asset class, can be a security vulnerability particularly when strategically located parcels are involved. The more typical concern is simply complicity in the laundering of corruption or criminal proceeds and, possibly, the creation of a commercial constituency dependent on facilitating the business. Here, too, governments fail to collect comprehensive information, typically allowing residential and commercial property to be held by legal entities, including shell companies, without reporting their beneficial owners. The United States has piloted a temporary program to collect purchasers' ownership information at the time of purchase through title insurance companies. This program is designed to collect the information through the Treasury Department at the national level, although property ownership is generally recorded at the county level. By all accounts, the pilot has gone well. It should be made permanent and nationwide, and it should be expanded to collect sellers' information too. The Canadian province of British Columbia has taken a different approach and is in the process of rolling out a program in which local tax and land authorities will collect the information.

In the last major category, bank deposits, the EU has been more aggressive than the U.S. Under the fifth AML Directive, the EU will create centralized registers of bank accounts at the beneficial ownership level. In the United States, equivalent information is available to law enforcement upon request but is not centrally compiled.

Beyond tracking foreign investment, there are two big additional information gaps. First, The United States has persisted in allowing the creation of anonymous companies, which facilitates all manner of illicit activity and makes investigations needlessly slow and difficult. The EU ended anonymous companies with the fourth AML Directive and is moving to public registers under the fifth. In the U.S., legislation to end anonymous companies has passed the House of Representatives and secured the endorsement of the White House. It seems that the end of this glaringly retrograde practice is in sight. Second, neither the U.S. nor European countries track cross-border payments in a centralized database. These databases would provide invaluable information for investigations, particularly when tracking the flow of funds through accounts held at multiple institutions in multiple jurisdictions. Australia and Canada have already done so.

All of these information collection measures, but especially the creation of centralized cross-border payments databases, are powerful. If abused they could become dangerous. It is therefore imperative to maintain strict access and audit rules to protect civil liberties. Refusing to collect this information while allowing ongoing unimpeded flows, however, is a recipe for failure.

An Evolution in Mentality

As much as any particular law, regulation, or practice, countering the security threat posed by illicit financial activity is equally about augmenting authorities' missions and coaxing them to work together in new and creative ways. The illicit finance challenge demands efforts from disparate groups – financial supervisors, law enforcement, and intelligence agencies – that generally do not work together or share a common approach, even if they are part of the same government.

Financial supervisors are concerned primarily with safety and soundness, investor protection, and market integrity. They are well-equipped to assess institutions' risk controls, but they are not usually tasked with identifying, and then determining the scale and purpose of, illicit flows through institutions under their supervision. Yet they may be best placed to spot the activity and to make other agencies aware of the bigger picture beyond a specific criminal case. Law enforcement agencies and prosecutors, by contrast, are expected to spend their limited time on investigations out of which a criminal case can be made. Securing a criminal money laundering conviction, even with all the training, resources, and information in the world, is difficult. Prosecutors must prove both that the activity stemmed from or facilitated an underlying criminal offense and that the perpetrators had knowledge of this fact. Intelligence agencies, of course, are tasked with seeing the bigger picture and focusing on the security threat, not what is provable in court. Yet they may lack the training, inclination, and access to information to tackle the illicit finance threat on their own.

Success will entail a change in mentality, better information-sharing, and tighter coordination, both within governments and across borders. Illicit financial facilitators understand and exploit all of these obstacles and frictions. The first step to success is a deeper understanding of why we have failed.