AML/CTF Tranche 2: What you need to know

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Tory Ishigaki: Welcome to InfoCast. I'm your host, Tory Ishigaki. Today I'm sitting down with Murray Lawson to discuss Australia's compliance landscape, how it's evolving, and what businesses can do to protect themselves. Murray is Senior Director in the Global Risk and Investigations practise at FTI Consulting, and leads a team of investigation specialists who work with clients to help manage and mitigate risk. In the due diligence arena, anti-money laundering and counter-terrorism financing have taken the spotlight of late. Murray, for those who are just starting to think about AML/ CTF, can you give a bit of background on what it is and why it's so important?

Murray Lawson: Absolutely. AML and CTF, anti-money laundering and counter-terrorism financing, refers to a broad program of international cooperation that is designed to protect the integrity of our financial system, and ensure it's not used by criminals and terrorists to help them achieve what they want to do. Money laundering and terrorism financing aren't exactly the same things, but many of the ways that they seek to conceal money and move it around, make it usable, are quite similar and can be approached in a similar way when we're trying to disrupt or make it difficult on them. Money launderers have focused on making sure they can convert illegitimate earnings into legitimate ones, make them appear legitimate so that they can use them. Terrorists are generally focused on concealing and moving their money so it can be used to achieve their objectives, which can be anything from funding attacks on the ground in various countries, through to paying the wages of their fighters or other mechanism they need.

In both cases, disrupting the ability to derive that financial benefit from illegal activities and to stop the money being used, is one of the most effective means that we have available of stopping that sort of activity. If we can interdict it, we can actually prevent some pretty serious activity. It's important when we think about AML/CTF and compliance, the conversation often becomes around regulation and government intervention, but it's really important to think about what it is we're trying to stop.

The ongoing conflict between drug cartels in Mexico killed 23,000 people last year alone. In one attack, a battle against the Islamic State in Syria this year, it's estimated that more than 40,000 civilians were killed. So, it's some pretty serious stuff that through international coordinated action under the AML/CTF regimes in various countries, we are collectively committing to ensuring that our financial systems aren't the unwitting accomplice to these sort of horrendous attacks.

It's why the Australian Government's a signatory to what's called the Financial Action Task Force. That's the global body that sets the standards for AML/CTF. It's from those standards that we get our AML/CTF Act, AUSTRAC, and our ongoing regulations.

Tory Ishigaki: I think that's an important point to make, because I think a lot of people see AML/CTF and then think "Oh, I'm going to get in trouble for not following these rules," but you don't think-

Murray Lawson: Absolutely.

Tory Ishigaki: ... behind the actual motives for why those rules are in place. And another thing with AML/CTF I have found is when we've tried to talk to people about it, maybe it's just the terminology, but then when we say "Due diligence," then they kind of it clicks in. So AML/CTF is essentially a form of due diligence, or something people should be doing as part of a wider due diligence procedure, or how would you ...

Murray Lawson: It's not really. AML/CTF is sort of a broader concept that says what businesses that are regulated entities providing particular services need to do in terms of how they engage with customers. Due diligence is one part of it, and that means things like understanding who their clients are, what they're involved in, what activities they're engaged in, but there's broader implications. So under the AML/CTF Act regime, regulated entities have to report particular transactions to AUSTRAC. AUSTRAC is the government agency responsible for two aspects of AML/CTF, one is its role as a regulator, and the other is as a financial intelligence unit. It doesn't collect the information from regulated bodies for nothing. It gets that for use by law enforcement, by our national security agencies, by the tax office, and it shares information with our international partners as well. These are networks of illegal and dangerous activity, and we share that information to help the global effort to stop it.

So AML/CTF is the reporting obligations, it's about saying who's moving money, is it suspicious, are they doing it in Australia as well as in the U.S., have they got a history of it, are we looking at a network?

The due diligence component is what regulated entities have to do in order to understand and obtain information. It's a bit broader than just due diligence, but due diligence is certainly a big part of it.

Tory Ishigaki: So you and I actually sat down about a year ago, and then we were already talking about Tranche 2 of the AML/CTF Act and how that was looming in the future, but you'd said you weren't sure, maybe something big would have to happen for us to take action. And now, there has been all of that news about the Big Four banks and all of these breaches, and obviously they don't have the right procedures in place. Can you explain a bit about what you think happened there, and how that's going to affect things moving forward?

Murray Lawson: I think there's a number of angles to this. I mean, it's hard to without having all of the facts, and there's been a lot of allegations to really say exactly what went wrong, but I think there's ... certainly highlighted that the regulator is taking more action now, and going forward, AUSTRAC will be looking harder, it will take enforcement action when it sees that it needs to be taken. Because it's very important that we make sure that Australia's not seen by our international friends as deficient. Our last mutual review with the FATF actually showed we

were lagging behind quite badly on a number of areas. The government is committed to really improving that. We're seeing changes at government to homeland security, that will increase that pressure.

I think some of the examples we've seen highlight the difficulties of maintaining compliance in an ongoing fashion and the constant attention that it needs. As businesses introduce a new technology or they change a new service, they develop the business model, it's really important that that then trigger a reassessment of whether there's still risk, has the risk profile of the business changed? What policies and procedures do they need to change to ensure that they're maintaining compliance to deal with the new technology? So I think there's some examples there. I think there's also been a slightly lower priority placed on some of this stuff previously that I think will change. We need to sort of keep vigilant as businesses to ensure that we're navigating that as best we can, meeting the obligations that the government expects us to, and that's the best way to avoid the regulations.

The other things I will sort of make a point of is that often we think about compliance as like this separate function inside a company, and we set up a compliance function that has the job of doing compliance, and it can create at times a situation where the decision makers on the frontline of the business maybe don't have as much insight into why the compliance issues need the attention they do. So I think what we'll need to see, is a refresher of that understanding at the operating level of what are the implications of a lack of compliance, understanding the risks of the decisions they're making on a day-to-day basis, and how to apply that in that decision making frame, and it not just be the compliance people dealing with it.

The final point I'll make is that like anything that deals with intelligence or law or things like that, what we're seeing are failures. What we're not seeing, and it's impossible to quantify how many potentially illicit transactions have actually been prevented by compliance succeeding, and I suspect that it is probably a lot more than the failures. But unfortunately, the failures are quite public, they are quantifiable, and that's sort of where we're at. But we have to remember that in most companies, they are trying their very best, and it's a collective engagement and effort between government and business to get this stuff right.

Tory Ishigaki: Do you think in terms of the banks, it's almost because they're so large and have so many transactions, is it more complex for them? If a smaller business is looking at this and thinking, "If a bank can't even get it right, how can I do it?" Is that ...

Murray Lawson: I mean, there's certainly large organisations have some complexities that are unique to them. I think for smaller businesses when they're thinking about this stuff, it can actually be a bit easier in that a smaller business probably has fewer transactions that it needs to worry about, fewer customers. Probably knows its customers better than the big banks. There's certainly less to get across. So you can actually do quite a bit in a smaller company that you might not be able to do in a large bank, for instance. So there's definitely challenges there. I think there's organisational challenges, like the one I just spoke about in terms of how do you

get compliance down to the operating level? How do you get that sort of flow through right?

Tory Ishigaki: Yeah. I found that really interesting actually, because we've been talking to quite a few in-house counsel lately, and they were saying how they've been trying to shift their role from being kind of like the red marker people and just compliance, to actually leading the business a bit more and being more innovative, and instead of saying "No, we can't do that. No, we can't do that," like "How can we do this, but obviously by complying?" And it seems like they're trying to make their role more integrated within the business and not be the singular compliance unit.

Murray Lawson: I think that's a really good approach. I think it has to be a collaborative situation where you're balancing the risk and the opportunity. And let's face it, we can't have a business that doesn't take risks, because if it doesn't take risks, it doesn't do anything. It's about balancing how do we, in an informed way, take that risk? That means understanding the situation better. It means things like greater due diligence. It means making sure you've got a solid tested independently reviewed compliance program that you know works. Because then you can have confidence. You can actually approach a new opportunity saying well, I know that the people are engaged with this have the right sort of thinking, the business can be more confident.

And there's actually a real return on investment to a good compliance culture. It means you can actually take on risks and understand them and assess them, that competitors who didn't have that sophisticated level of compliance culture can't, or if they do they might get it wrong. So compliance shouldn't be seen as sort of the cost on the business, it should be a way of managing the risks that good opportunities present to you.

Tory Ishigaki: When you're working with your clients, do you ever go in and kind of assess their compliance culture? What do you find are the main gaps that they have or the weaknesses, or what ...

Murray Lawson: I think one of the main gaps is that ongoing vigilance. A lot of times we see the sort of compliance program was written three or four years ago, and it's been in place and it's become just a routine of this is what we do in X situation, but there's not necessarily been a recognition that some of the aspects about the business have actually changed quite a lot in that time, and that maybe that program isn't actually fit for purpose anymore, but no one's actually gone back and gone "Hang on, that really doesn't suit. It suited how we did business then, but it doesn't suit how we do business now." You know, with things like greater digitization, online platforms for interaction with customers, it changes fundamental aspects of things that impinge on your compliance. And I think going back and looking at that is really, really important.

Inadequate risk assessments are always an issue. Making sure that you really do understand where the risks are at, because understanding that underpins how you approach the compliance, so if the risk assessment's wrong or it's not comprehensive enough, you then have a structural weakness in your compliance

program from the get-go, and you need to put attention on that. The lack of refresher training as people change roles and move, is often a big gap. They just kind of get a handover and it says "You go through this particular checklist," without really any understanding of why we're doing it, and that gets a little bit lost. I think that presents a pretty big risk as well.

So I think there's a whole host of weaknesses that can pop up, not necessarily any that are intentional, but just inadvertently.

Tory Ishigaki: So right now, there's obviously a lot of talk in the news about reform, calls for reform, and there's discussions on Tranche 2 and when that will be implemented. Is that likely to come into place in 2018?

Murray Lawson: I would strongly suspect it will. The legislation seems on track. The review certainly highlighted that it was needed. We've already had some legislation to reform various aspects and implement parts of the review. And I think the government is strongly committed to the reforms in this area. The structuring of the homeland security department I think gives a bit of a signal about how the government's thinking on national security and these sorts of issues, so I can't see them shying away from greater reform. And I would suspect it'd probably come in next year at some point.

Tory Ishigaki: What do you think will be the main impact on the people who are going to be covered by Tranche 2, and what kind of challenges would they face now?

Murray Lawson: I think there's going to be some real challenge in terms of the matchup between the way the regulations have been written to suit financial transactions, fairly customer relationship type situations. They're quite different when you start talking about real estate sector or lawyers or accountants. The nature of the relationship with the client is sometimes different. So I think there will be some challenge in just getting the settings right for what their compliance program needs to look like tailored to their business.

For instance, one of the questions I had in a recent seminar was how do you deal with verifying information that's provided to you from an offshore customer in a conveyancing transaction where you're kind of having to do it quick because it's a transaction. How do you do that? What do you do about it? You can't necessarily verify back in an offshore jurisdiction that this identity document is correct. It's about understanding how to approach that, and I think there will be mature conversations to be had with AUSTRAC. And I think for those businesses that are going to be newly regulated under the changes, the approach of AUSTRAC will be at first very educative. It will be collaborative. They will try and do as much as they can to work with business to help them understand what the new regulations are going to mean. But the onus is on the business to do a fair bit of the thinking itself as well.

Tory Ishigaki: And for those businesses that aren't yet regulated and won't fall under Tranche 2, should they still be thinking about this? What kind of procedures can they have in place?

Murray Lawson: Look, I think whether or not you're regulated under AML/CTF, if you're providing services to a customer that are potentially high-risk, understanding who that customer is is really important for your own benefit, whether it's a supplier that supplies you goods, you need to know where that's coming from. You need to understand who that person is, and you need to understand that they're someone you actually want to do business with. So I think there's always a call for due diligence. There's always a call to know who you're dealing with in business, particularly if it's a business partner offshore, the more you know, the better off you are. There's a lot of good reasons to do due diligence outside of AML/CTF, whether it be to avoid issues of bribery and corruption, international sanctions issues, or just to ensure that if the business deal goes wrong, you're able to take some action against this person.

Tory Ishigaki: And for the lawyers and conveyancers and real estate agents and all those people who will fall under Tranche 2, what can they start doing now to kind of in anticipation of that coming into place?

Murray Lawson: I think first start with talking. Get educated about what these requirements are going to mean for your business. It means getting the conversation at senior management level, at board level, understanding that this is coming. It's going to require some changes to the business. There will be different things that need to happen. The other thing I'd be starting to look at is how much information do you already have in the business? Most major companies have some sort of onboarding of customers nowadays, so you're probably collecting quite a bit of the information you're going to need to be compliant, but maybe you're just not putting it all in the right order, or collecting it in the right way. So I think there's real scope adapt processes rather than necessarily having to wholesale introduce an entire new system. It's about saying "Well, how much information do we already have," and maybe you just need to increase that by 10% to be compliant.

Conducting a risk assessment I think is always a good idea. You can get advice on how these things apply to your business. My company's just one of many who do this sort of work, where it's really about getting an independent person who understands the compliance framework to look at your business and say "Look, this is where I think your levels of higher risk of non-compliance would be." And then you at least start to have a priority list of things that you're going to have to tackle. Don't look at it as something that you've got to do all at once on day one of the act coming in. There will be, as I said, AUSTRAC will be quite collaborative, but what they'll want to see is that you're starting with the highest risks first, and that you've got a program to try and start to get ready for this stuff. There will be probably a reasonable implementation period once the changes come in, so it's about knowing ahead of time "Well, what does that work plan look like," so that you're not scrambling to try and catch up.

So I think they're probably the key things at the moment.

Tory Ishigaki: I know two key things kind of to investigate in this whole AML/CTF process are politically exposed people and beneficial owners. Can you just give a bit of a highlight on why those are important?

Murray Lawson: Yeah, absolutely. So politically exposed people are people who under the AML/CTF regime present a greater risk of being engaged in money laundering or terrorism financing. It really stems from the fact that a politically exposed person is someone who holds a senior position in a government or an international organisation and their family members and associates. It stems from the fact that in those positions they've traditionally been at high risk of corruption. Corruption produces money, and that money then needs to be made clean, which is where the money laundering comes in.

So corruption's what we call the predicate offence to money laundering. It's one of the ways that money's generated, and politically exposed people through virtue of their position, their ability to influence government policy to issue licences, whatever, are a corruption risk, and really, within the AML/CTF regime, it's a reflection that people who hold those positions are people that need to have a greater level of scrutiny. Now, that's not to say that a politically exposed person can't be a customer of the business, it just means that you've got to be a bit more vigilant. You have to go through extra due diligence work to ensure that relationship's appropriate.

Tory Ishigaki: What would that look like, that digging deeper?

Murray Lawson: It may be things like having senior management oversights. It may mean documenting, getting an understanding of where this person's wealth comes from, is it legitimate wealth? You know, a politician who has only ever worked in government but yet has hundreds of millions of dollars from a high-risk jurisdiction with no explainable sense of where that money comes from, maybe you just need to start thinking, you've got to ask a few more questions, versus he's a well-known entrepreneur who made his millions before he went into parliament, that's a very different scenario. It's about understanding those scenarios, and then factoring that into the risk of what the engagement with that customer looks like.

Beneficial ownership is sort of a separate issue, and really relates to who controls your customer. So particularly when you're dealing with a business, beneficial owners are those who own 25% or more of the business, or exercise significant control over the business and derive a profit from it. It's those people that under the AML/CTF regime that you need to know who they are and be able to verify their identity, and that's to ensure that they're not politically exposed people or that this isn't some front for illegitimate organisations to be doing something.

Tory Ishigaki: How do you determine if they have significant control?

Murray Lawson: It can be disclosures from the customer themselves. They should be able to provide you a corporate structure showing who owns what. It can be checks through ASIC, through various other platforms around the world where you can get business ownership information to understand who owns and controls a particular company, or certified documents of share registries or things like that. It just depends on the particular scenario as to what information's available and what you can ask for.

Tory Ishigaki: So there's a lot of focus on these external relationships, but there's also the matter of kind of internal due diligence. I've heard you talking about that a bit before, can you explain?

Murray Lawson: Under AML/CTF, you will be required to conduct some sort of due diligence on employees inside the business who may be assessed as in a position of risk where they can facilitate money laundering. That might mean anything from just checking their employment background, making sure that they've not been involved in anything challenging. Or [if they're identified as a high-risk position, then it might mean looking at things like criminal records checks, checking they've not been the subject of regulator enforcement actions, they've not lived in a sanctioned country and have got extensive networks into places that could present a risk. So it'll just depend on the unique business where the risks are, and who's doing it.

Tory Ishigaki: What are your thoughts on bitcoin? Do you think that will be used for money laundering eventually?

Murray Lawson: I'm very confident it already is.

Tory Ishigaki: It is? Okay.

Murray Lawson: The thing about organised criminal groups, is they are very sophisticated and very quick to adopt new technologies and exploit them. Bitcoin is opaque. It's very, very opaque, so it will naturally present a convenient way to move value and move currency. I don't think the checks and balances on the system are there that would prevent it, and it's very hard to prove what's called placement. So the first stage of money laundering is placing. That is how you get your illegitimate funds into the system, depositing in a bank account, whatever. The disconnect with bitcoin is there's no linkage between the placement, the layering in-between, and the exfiltration of the cash at the end.

Tory Ishigaki: So there's not that chain of evidence there.

Murray Lawson: It's very hard to establish that chain through and show it, so it's naturally going to be a very attractive option. I would suggest that probably some of the value that's being moved around in bitcoin is as a result of dark money going through it. It's going to be a challenge for regulators around the world to deal with it.

Tory Ishigaki: Are there any other kind of emerging threats in the landscape that you foresee in the future?

Murray Lawson: Yeah. I think sort of the digital currencies are one. In Australia we're about to see what's called the New Payments Platform come in, and that is a way of immediate settlement of transactions between financial institutions. You'll no longer have 24 hours to wait for it to transfer money from one bank to another. What that means is that the overall tempo of financial transactions is going to increase dramatically, which means that it may be possible to move money through multiple banks, multiple accounts in a very short space of time. So from the perspective of tracing or defending against illicit funds transfers, it's going to

be much, much harder. That means that a good compliance system, good customer onboarding, all of that will be needed to try and defend as much as possible against bank accounts being used for the wrong purposes. I think it's going to present some interesting challenges.

Tory Ishigaki: Any sort of last words of wisdom for people who are looking to update their compliance procedures in the new year?

Murray Lawson: I think getting independent health check is always good. Get some outside perspective on it, and think about what's changed in the business now that is different, because that will inform what you need to think about. Is it still fit for purpose? Does it still fit the way you do business? And even thinking about, well, if you're going to through the process of a review, what's on the sort of short to medium-term horizon for the business that may have an impact back on their compliance. The other thing is a constant conversation about where compliance fits.

And it's not just the responsibility of one particular section of the company, it's a responsibility of the people engaged in those decisions to have an awareness and understanding of how their decisions need to be made. It shouldn't be a competitive tension between different parts of a business, it needs to be a conversation, it needs to be a collaboration. Because protecting the business from the issues that come when there is a breach of regulatory compliance, we're no longer just seeing regulator action. A regulatory compliance issue is then quickly followed in today's world by a shareholder class action, various other shareholder activism issues. It morphs very quickly into something that's beyond what it needs to be. So compliance is really important because there are very good reasons why in and of itself it's important, but there are also other risks that it can pose to the business outside of just the relationship with the regulator.

Tory Ishigaki: Yeah. Thanks for coming in today, Murray. It was great speaking with you again.

Murray Lawson: Pleasure.