Money Laundering in Securities Markets

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This article was originally published in the July/August, and September 2000, editions of The Money Laundering Bulletin, London, England.

Introduction

It is widely accepted that securities markets, and stock exchanges in particular, are rife with money laundering. However, there is very little empirical evidence to assess the scale of the problem. There are no reliable statistics; most of the evidence is anecdotal. Nonetheless, the growing body of criminal cases and regulatory actions, coupled with other information from within the securities industry, as well as the criminal world, confirm that money laundering in the securities industry is an immense problem.

This article provides an overview of the securities market’s potential for money laundering, with the intent of alerting securities regulators to the need to be more vigilant, and encouraging law enforcement officials to focus more resources on this neglected aspect of money laundering.

Scope of the Problem

It would be naïve to deny that there is significant money laundering through securities markets. There is simply too much money changing hands for a certain portion of it not to be dirty. Where there is money there will be money laundering. For example, British police have uncovered various schemes to launder money through the London Stock Exchange (LSE). The problem is certainly not limited to the LSE. The liquidity and relative lack of regulation on the United States Over-the-Counter Bulletin Board (“OTCBB”) has made it a prime target of money launderers. However, evidence to support the argument is based on no more than a handful of documented cases. We can extrapolate from those cases and conclude that the problem is enormous but there are no reliable statistics to support the conclusion.

After undertaking a study specifically intended to measure the problem, the International Organization of Securities Commissions (“IOSCO”) concluded “the consultations revealed few publicly reported instances of money laundering in [securities and futures] markets”\(^1\). The Financial Action Task Force on Money Laundering (“FATF”) says: “[T]here is good reason to suspect that money laundering may pose a substantial threat in [derivatives and security markets]”\(^2\), yet offers scant evidence to support its conclusion. At the moment we have little more than suspicion, albeit a well-founded one.

The sheer magnitude of transactions in securities markets and the ease of moving funds make the market an obvious target for dirty money. Unfortunately, because there is little to differentiate a routine transaction from one intended to launder money, securities industry professionals and regulators are blind to the problem. Law enforcement professionals, experts on countering money laundering in other areas, lack the necessary expertise to unravel schemes to launder money through securities transactions.

Primary vs. Secondary Laundering

To put the issue in proper context, it is necessary to differentiate between ‘primary’ and ‘secondary’ money laundering. Primary money laundering involves transactions designed for the primary purpose of concealing or obscuring the illicit source of wealth. It is a conscious attempt to launder dirty money.

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Secondary money laundering is laundering in a technical or legal sense, but is merely incidental to the primary offence. For example, someone attempting to manipulate the share price of a stock must necessarily move money around. Similarly, wealthy drug traffickers invest in the stock market just like everyone else. By most countries’ legal definitions they are laundering money in the process. Most documented examples of money laundering in securities markets fall into this category. They are the most prevalent, yet they are the least interesting and relevant.

This article will focus on the more important and less understood, primary money laundering.

**Laundering Stages**

Money laundering is typically viewed as occurring in three stages: placement, layering, and integration.

**Placement**

Placement is the initial conversion of illicit cash into a non-cash instrument. This, to most people, is what money laundering is all about, the legendary ‘smurfs’ walking into banks with bags of cash. There is relatively little opportunity for dirty cash to be placed through the securities industry. Use of cash in securities transactions is relatively unusual and is actively discouraged by securities firms and their regulators.

Perhaps because of this perception that the industry is not at risk for receiving dirty money, brokers tend to be less vigilant in screening cash from clients than they ought to be. Clients *do* tender cash, and do so without the same level of scrutiny that they would face in banks or currency exchanges.

The placement stage is where the majority of law enforcement resources and suspicious transaction reporting regimes are targeted. Placement is the most obvious and most vulnerable stage of money laundering. However, the amounts involved tend to be small (relatively speaking), and the subjects identified are often nothing more than low level couriers. The truly culpable do not dirty their hands handling cash.

**Layering**

Layering is the conversion and movement of monetary instruments to conceal the source of the funds, and obscure the trail for law enforcement. The securities industry is the ideal vehicle for layering dirty money. Transfers to and from secrecy and tax havens are accepted industry practice, large sums of money routinely change hands without attracting unwanted attention, international transactions settle reliably within a few days, and money can be converted into any variety of exotic assets, incomprehensible to any but the most knowledgeable investigator.

Try walking into your neighbourhood bank and asking to transfer $100,000 from a bank account in the Cayman Islands. The same transaction in even a modest sized stock brokerage is routine. Transactions that are easily arranged and executed within a few days can take years for law enforcement officials to trace, if they can be traced at all.

**Integration**

Integration is the return of illicit wealth to the criminals in a form that gives them a cloak of legitimacy and allows them to enjoy the fruits of their crime, without attracting the attention law enforcement or tax officials. The majority of tax authorities’ resources are focused on integration. Unaccountable increases in net worth can result in punitive taxes, penalties, or jail terms. What better explanation to mollify nosy neighbours, police officers, and tax auditors than proof of a “dot.com” stock market windfall.
Methods

The following are real life examples, albeit simplified, of how securities markets are used to launder money. The examples are all drawn from actual situations encountered by the writer during criminal or regulatory investigations. The same scenarios are repeating themselves every day in every market in the world.  

Layering Typology

Brokerage accounts are ideal for layering dirty money. The account statement in Figure 1 is a reproduction of an actual monthly account statement seized during the course of a stock market manipulation investigation.

<table>
<thead>
<tr>
<th>Security Positions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quantity</td>
</tr>
<tr>
<td>----------</td>
</tr>
<tr>
<td>550,016</td>
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<tr>
<td>8,384</td>
</tr>
</tbody>
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The suspect account was held at a small stock brokerage in Canada. The account was opened in the name of a U.S. incorporated nominee company. As far as can be determined, the person named as having

3 Names and other identifying details have been changed to protect client confidentiality. For ease of explanation brokerage fees, typically 3% – 6%, have been omitted from the illustrations.
authority over the account does not exist. The suspected beneficial owner of the account is a former employee of a U.S. broker-dealer shutdown by regulators for fraudulent practices. The few securities that traded through the account are subject of various Securities Exchange Commission (S.E.C.) hearings and criminal investigations.

Figure 1 shows only one month’s transactions, however it is representative of the account activity over a several month period. Physical share certificates, registered in the name of a Bolivian lawyer, were delivered into the account. Money was regularly wired in from third parties in the Bahamas and Florida. Small wire transfers, always less than $10,000, were then made to nominee bank accounts in the United States. In one case there were three wires to the same person on the same day at three different banks.

There was minimal trading in the account, there were numerous third party transactions, offshore transactions, and transactions structured to avoid reporting limits. All of these transactions were executed quickly and at minimal cost on nothing more than the faxed instructions of a non-existent person. The suspect successfully defrauded investors in the United States. Through the use of a single foreign brokerage account and an offshore bank he effectively hid his profits from the S.E.C. and the U.S. Internal Revenue Service.

Despite the obvious red flags, neither the broker nor the credit and compliance staff of the firm considered the activity suspicious enough to alert money laundering officials. A diligent broker ought to have recognized and reported this conduct. Because each individual transaction, in itself, was routine, it did not occur to this broker that he was facilitating money laundering.

**Misappropriation Typology**

The Misappropriation Model allows criminals to repatriate dirty money from offshore and use it to finance an extravagant lifestyle without attracting attention and legally avoid paying income tax on the money. Figure 2 illustrates the structure.

Criminals start by taking control of a publicly traded shell company. There is an endless supply of such corporations available for as little as $500,000 from “shell brokers”, who do nothing but incorporate companies for the sole purpose of having vehicles available for companies wishing to go public. For their money purchasers receive a controlling interest, and a list of minority shareholders to create the appearance of being a widely held company.

Holding majority control, the criminals appoint themselves as directors and officers of the company, and formulate an illusory business plan to justify the company’s existence. Shares are issued to anonymous offshore companies in return for the criminals’ own dirty cash. These financings are occasionally by public offerings approved by securities regulators or stock exchanges, but are more often through special financings such as private placements or, in the United States, issuance of restricted Regulation “S” or Regulation “D” shares.

The company uses the new funding to pay its officers and directors — criminals all — outlandish salaries, and pay for their luxurious company cars, extravagant ‘business’ entertainment, and business travel — invariably to exotic locales. The criminals enjoy the lifestyles of the rich and famous, without paying any tax, and enjoy the legitimacy afforded by being officers of public companies.

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4 Private Placements are an issuance of shares from treasury without issuing a prospectus, typically to a small group of wealthy, ‘sophisticated’ investors.

5 Regulations “D” and “S” are sections of the U.S. Securities and Exchange Act regulations exempting issuers from prospectus requirements in limited circumstances, for example employee compensation or, in the case of Regulation “S” issuance to non-U.S. residents.
In a case uncovered by the Vancouver Stock Exchange (“VSE”) – now the Canadian Venture Exchange – an issuer sold a large private placement to an anonymous offshore corporation. VSE surveillance staff subsequently identified excessive spending on office, administration and entertainment expenses. Closer examination disclosed unacceptable expenditures, such as corporate meetings held in Hawaii, and invoices that appeared either forged or created after-the-fact. A previously undisclosed principal of the company was identified as the beneficiary of much of the spending. He was found to be under criminal charge for cocaine trafficking. He was laundering his cocaine money through the treasury of this publicly traded company. Trading was halted in the company until the unacceptable officers and directors were removed from the company.

**Manipulation Typology**

Stock market manipulation is a fine art unto itself; one which many people have unfortunately mastered. The mechanics of stock manipulation are fairly simple, however significant start-up capital is needed to establish the necessary momentum – to prime the pump so to speak. Money launderers can provide that start-up capital. Money laundering and market manipulation make a perfect marriage.

**Figure 3** illustrates how manipulators and launderers work together for their mutual benefit. The manipulator acquires control of a publicly traded shell company. Shares in the near worthless shell are issued to the criminal, in his or her own name, for pennies per share. These shares are often issued for free in return for phantom ‘consulting services’, or bogus assets.

The criminal sets up a brokerage account in the name of a nominee corporation domiciled in a secrecy haven. The shares are sold from the criminal’s own account to the offshore corporation at prices set by the manipulator. The shares trade back and forth repeatedly, at progressively higher prices. In the final round, the criminal sells the shares, originally worth pennies, to the offshore corporation for hundreds of times the original cost. The criminal has a huge stock market windfall, duly reported to tax authorities as a capital gain. The offshore corporation apparently suffers a catastrophic loss when the share price collapses.
If the manipulator augments the price run-up with other techniques, such as phony press releases, Internet promotions, or boiler room tactics – the classic pump-and-dump – the remaining shares can be unloaded on innocent investors at enormous profits. The truly greedy make even more profit short-selling the worthless stock on its way back down.

Figure 3 shows an example of exactly this situation. It is the price and volume chart of a Vancouver-based OTCBB stock. Since no criminal charges have ever been laid and the company still trades, nominally, on the OTCBB we’ll just call it Salt-Job Mines Inc. Salt-Job was ostensibly in the mining business. Its share price went from pennies to $25.00, and back again in a matter of weeks, without ever doing any legitimate business. The primary beneficiary of the price rise was a group led by two well-known and extremely violent career-criminals. Before the price was run-up members of the group received free shares in return for ‘consulting services’.

Confidential information confirms that the group had delivered $3 million cash in a suitcase for deposit to their nominee account at a Caribbean brokerage firm. That firm was the largest net buyer of the Salt-Job’s stock. The criminals sold their Salt-Job shares through their personal accounts at Vancouver brokerage firms. The scheme could have continued except that another member of the group, the past-treasurer of an outlaw motorcycle gang, and a close friend of the stock promoter, was found murdered the week the stock reached its peak. Despite the unexplained price rise and apparent catastrophic losses by the offshore buyers, no disgruntled investors ever complained to police or regulators.
Leverage Model

This might better be called the “YBM Model”, in honour of YBM Magnex International Inc. (“YBM”), a company alleged to have been created for the primary purpose of laundering criminal proceeds on behalf of Eastern European organized crime. YBM was, ostensibly, a producer of industrial magnets, a tangible product. It was only a matter of time before their façade of modern factories and burgeoning demand for what was, essentially, a commodity, could not be maintained.

YBM began as a Junior Capital Pool (“JCP”) on the Alberta Stock Exchange. JCPs are trading entities intended to pool venture capital to invest in viable start-up companies. Because of their limited assets and lack of business history the shares typically trade very cheaply, and are closely held. The magnet business was vended into the JCP, creating YBM. YBM’s revenues and profits, and as a result its share price, rose exponentially. At its peak YBM’s share price was over $20 Cdn. The criminals and their nominees had received these shares for pennies when YBM was in the JCP stage. When regulators finally halted trading the company’s shares had a market capitalization of over $600 million Cdn., most held by innocent investors.

Criminals have already learned YBM’s lesson. Instead of producing industrial products that auditors, investment analysts and police officers can see and touch, the new sham public companies sell intangible cyber products, such as Internet gambling.

The method remains the same (illustrated in Figure 5). The criminals take control of a publicly trading but virtually worthless shell company – Internetlaundry.com in our example. Internetlaundry.com invests a nominal amount in an Internet site that promotes online gambling. It purchases a gaming licence from a hospitable foreign country. Internetlaundry.com satisfies domestic gaming regulators by offering its services only to foreign clients. The criminals deposit their dirty cash into a secrecy-haven-based bank, and take out credit cards from that bank in various nominee names. The nominees sign up with the gambling service, and place a series of large money-losing bets. Internetlaundry.com receives direct payment from the credit card company. The credit card bills are then paid off with the criminal’s own dirty money.
The credit card records and steady cash flow satisfy auditors that Internetlaundry.com has genuine revenue. Audited financial statements showing impressive profits attract new investors. Since the price of a company’s stock is typically a multiple of its earnings – often several hundred times earnings in the case of Internet stocks – the increased value of the criminal’s holdings in Internetlaundry.com more than compensates for the money ‘lost’ gambling and eaten up by start-up expenses.

In this model the criminals not only legitimize their own dirty money, they multiply their profits several times over.

![Leverage Typology](image)

**Figure 5**

**One Approach to Prevention – the VSE**

As a self-regulatory organization the VSE is required to regulate the conduct of its member firms and trading in its listed companies. Despite, or more likely because of, its checkered reputation the VSE has, for the past several years, taken an aggressive, proactive approach to fraud and money laundering on its market.

The VSE takes a three-pronged approach to regulation: Listed Company Surveillance, Trading Surveillance, and Enforcement.
Listed Company Surveillance

Listed Company Surveillance conducts ongoing reviews of all companies trading on the Exchange. Officers and directors are vetted for suitability. Those with questionable pasts are removed from positions of authority in the companies. News releases are screened for compliance with Exchange rules and general propriety. Listed Company Surveillance also reviews audited financial reports to ensure, among other things, that funds are not diverted for purposes not approved by shareholders. To enforce compliance, trading is halted in offending issuers until the situation is corrected.

Trading Surveillance

Trading Surveillance uses proprietary software to monitor trading real-time. Anomalies in price or volume are immediately investigated. Surveillance staff has the authority to require explanations from issuers for any sudden changes and to compel brokerage records to identify people responsible for the trading. Again, where there is no rational explanation for large price and volume changes, trading is halted until the necessary information is provided.

Investigation

The VSE vigorously pursues employees of member firms who violate Exchange regulations or other securities rules, and remove them from the industry where required. In one recent case a broker was banned for life for failing to use due diligence on accounts that the Exchange ruled he ought to have known were being operated on behalf of organized crime.

In addition to specific rules governing conduct, the Exchange also enforces what it calls a ‘Gatekeeper Rule’. Member firms and their employees are expected to act as the front line in securities regulation. They must use their professional judgment to prevent deceptive trading and screen out unsuitable clients. A newly implemented measure allows the Exchange to audit the quality of due diligence performed by member firms prior to public offerings.

The VSE has suffered criticism from issuers and shareholders for its proclivity to halt trading in suspicious circumstances. However, this aggressive approach is a necessary deterrent to fraud and money laundering on the Exchange. Despite the criticism, the VSE’s strict policies have succeeded in diverting scandals like YBM and “Salt-Job Mines” to other, less regulated markets.

Recommendations

Increased Vigilance by Regulators

Securities regulators, including government bodies and self-regulatory agencies, need to take a greater role in preventing and exposing money laundering. This will first require recognition by them that it is their problem, followed by intensive training of investigators, and enhanced liaison and cooperation with law enforcement. Finally, they must be prepared to act decisively.

Most regulators acknowledge money laundering as an issue in the securities industry. However, to date, money laundering prevention and enforcement has been viewed as being the responsibility of criminal authorities. Regulators need to recognize that money laundering poses a significant threat to the integrity of securities markets, and that criminal authorities lack the expertise and resources to deal with the problem. Only regulatory authorities have the knowledge and broad powers necessary to reduce money laundering in their markets.

Regulatory investigators understand the securities laws and investigative procedures; however, they are not typically trained to identify and investigate money laundering. They need to be provided specific anti-money-laundering training. Front line investigators should be attending money laundering conferences and training programmes, despite the fact that the emphasis of most such events is the criminal justice system. Specific securities-related training should be developed in cooperation with law enforcement experts.
Most of all, regulators must overcome the naïve belief that anomalous trading patterns are nothing more than the ‘unfettered magic of the invisible hand of market forces.’ When there is suspicion of impropriety regulators should not be reluctant to intervene.

*Increased Attention by Law Enforcement*

Increased vigilance by securities regulators is not sufficient. Law enforcement agencies must pay more attention to the securities markets. Police have historically neglected large-scale money laundering in securities markets. The reasons are twofold: it is time-consuming and difficult to prove that securities transactions are for the purpose of laundering money, and few police officers have sufficient knowledge of securities markets to conduct such investigations.

Most anti-money laundering teams are now multi-disciplinary, utilizing accountants, lawyers, customs agents, and tax authorities working alongside police. Securities regulators need to be drawn into those teams. Systems have been established to ensure that the special powers held by other regulatory agencies are not abused, and do not compromise criminal proceedings. The same can be done for securities regulators.

Finally, just as securities regulators need to invest in money laundering education, police must invest in securities training for front-line investigators. Money laundering investigators are conversant in the practices and jargon of the illicit drug trade. They must be equally conversant with the world of finance.

*Conclusion*

The putative problem of money laundering in the securities markets does exist, and on a large scale. Criminals are well ahead of law enforcement in this field. The examples provided are only a few of the myriad of methods that money launderers are already employing in the market. Securities regulators and law enforcement must each improve and increase their investigative capabilities, and must work together to attack the problem.