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**Money laundering and financial crimes: a comparison between  
criminal and legal firms**

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## ***Introduction***

Since the globalization era has emerged, it has involved the international integration of capital, technology and information in a manner that the world results a single global market. This integration enables individual and corporations to reach around the world faster and cheaper than ever before. However the same aspect of globalization that have expanded opportunities for free market capitalism also has created new risks. Globalization has turned the international financial system into a money launders' paradise.

Money laundering is one of the most critical thing that worries governments and in order to fight this problem is important to understand this global threat.

This thesis is structured in four chapter. The first chapter describes what it is money laundering and its three stages.

The first stage involves the placement of proceeds (derived from illegal activities) from the scene of the crime to a place or in a form less suspicious and more convenient for criminal.

The second stage of money laundering is the layering phase and involves the separation of proceeds from the illegal source through the use of many methods described in the chapter; this phase is useful to increase the difficulty of tracing the proceeds back to its illegal source.

Integration is the last stage of money laundering and represents the transformation of illegal proceeds into apparently legitimate business earnings; it creates the illusion of a legitimate source for illegal funds.

The second chapter is focused more on the role of the companies in the money laundering process. It explains the methods and techniques used by criminals to misuse companies in order to launder money.

Criminals needs legitimate business in order to justify the source of their illegal funds: in the hands of a skilled launderer, the payment for goods (for example) that appeared to have been delivered by one firm based on an invoice of sale prepared by another company, covers the laundering of the purchase price when the goods never existed and the companies are owned by the same group of people.

The third chapter describes international and domestic anti-money laundering regulations. The set of laws introduced by each country involve both the aspect of persecution and strengthening of a prevention system based on cooperation between public authorities and private operators. The aim of this cooperation is to identify each possible suspected transaction of the proceeds of crime in the legal economy. An example of money laundering prevention could be the rules that limit the use of cash, or the rules that impose to banks and professionals the obligations to cooperate with authorities on seizure and confiscation measures. In the chapter are described the Recommendations of FATF (Financial Action Task Force), the main EU Directives about money laundering, and incorporation of

international guidelines within national policy-making.

The fourth chapter is committed to a statistical analysis of criminal companies in order to find some features that are typical of companies that are misused for money laundering purposes. The data analysis is conducted with the comparison of the main financial ratios of criminal companies with those of clean and legal companies that have received a Legality Rating.



# ***CHAPTER 1***

## ***What is Money Laundering?***

Criminals collect relevant amount of money derived by committing crimes such as drug trafficking, investment fraud, corruption, extortion. They will initially seek to prevent their actions from being noticed by law authorities, especially they will try to hide the origin of the significant sum of money in order to avoid the confiscation. When criminals want to spend dirty money, they have to face a problem: how to spend or invest large sums of money without evidence that draw the attention of tax examiners, auditors and authorities?

In order to be able to spend money without restraints, criminals will seek to build a clean explanation for an apparent legal origins of the money which they possess; in this way, criminals attempt to “launder” their proceeds of crime before spending or investing their dirty money in the legal economy.

### ***1.1A brief history***

The phrase “money laundering” was first coined at the beginning of 20<sup>th</sup> Century. The criminalization of the actual or attempted laundering proceeds of crime is also quite recent. However the practice of concealing income, derived from illicit activities, can be traced back to the 5<sup>th</sup> Century.

In fact, in the Middle Ages, when Catholic Church banned usury, that was considered as a crime and a mortal sin, merchant and money lenders, intent on collecting interest on loans, engaged in a vast variety of practices that anticipated modern techniques for moving, hiding, and washing criminal money. The central objective was to make interest charge disappear (hiding its existence) or appear to be something other than what they really was (disguising its nature).

This scheme trick could be accomplished in several ways: when merchants negotiated payments over long distances, they would unnaturally inflate the exchange rate enough to cover interest payments as well; or they would claim that interest payments were a special premium that compensate the risk; or they would make interest appear to be a penalty for late payment (with lender and borrower implicit assenting in advance that such delay should take place). All of these tricks, used to mislead the Church authorities, have their equivalents today in the methods used to launder criminal money flows.

The term money laundering was originated in 1920's during the period of prohibition in the United States. The organized criminals in the United States had got greatly involved in the profitable alcohol smuggling industry and for legalizing their profits they started combining their profits with the profits from legislative business. But according to Robinson, it wasn't until the 1973 that the term actually appeared in print for the first time in relation with the Watergate scandal<sup>1</sup>. He says that this case describes the money laundering perfectly despite of its origin; in that case the dirty or illegal money was put through a series of transactions and the money appears clean or legal at the end.

Money laundering, as a crime, only attracted interest in the 1980's, essentially in relation to the drug trafficking context in America. It was from an increasing awareness of the huge profits generated from this criminal activity and a concern at the massive drug abuse problem in western society which created the impetus for governments to act against the drug dealers by creating a legislation that would deprive them of their illicit gains.

## ***1.2 Definition of money laundering***

In this paragraph we want to give an overview of the many existing definitions of money laundering:

- ❖ When the following conduct is committed intentionally it is money laundering:
  - the conversion or transfer of property derived from criminal activity for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who

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<sup>1</sup> Robinson J., *The laundrymen: inside the money laundering, the world third largest business*, 2013

is involved in the commission of such activity in evading the legal consequences of his action;

- the concealment or disguise of the true nature, source, location, disposition, movement or rights with respect to, or ownership of, property, knowing that such property is derived from criminal activity or from an active participation in such activity;
  - the acquisition, possession or use of property, knowing, at the time of receipt, that such property was derived from criminal activity or from an active participation in such activity;
  - participation in, association to commit, attempts to commit and aiding, abetting, facilitating and counselling the commission of such actions<sup>2</sup>.
- ❖ A person commits the offence of money-laundering if:
- the person acquires, possesses or uses property, knowing or having reason to believe that it is derived directly or indirectly from acts or omissions which constitute an offence against any law punishable by imprisonment for not less than 12 months;
  - or renders assistance to another person for the conversion or transfer of property derived directly or indirectly from those acts or omissions, with the aim of concealing or disguising the illicit origin of that property, or of aiding any person involved in the commission of the offence to evade the legal consequences; or concealing or disguising the true nature, origin, location, disposition, movement or ownership of the property derived directly or indirectly from those acts or omissions.<sup>3</sup>
- ❖ Money laundering is the processing of criminal proceeds to disguise their illegal origin.<sup>4</sup>
- ❖ Money laundering is a process in which assets obtained or generated by criminal activity are moved or concealed to obscure their link with the crime.
- ❖ Money laundering is any act or attempted act to conceal or disguise the identity of illegally obtained proceeds so that they appear to have originated from legitimate sources.<sup>5</sup>

Robinson gave one of the most complete definition said that “ *money laundering is called what it is because that perfectly describes what takes place illegal, or dirty, money is put through a cycle of transactions, or washed, so that it comes out the other end as legal, or clean money. In*

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<sup>2</sup> Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of Money Laundering [Official Journal L 166 of 28.06.1991]

<sup>3</sup> United Nations Office on Drugs and Crime (UNODC), UNODC model money-laundering, proceeds of crime and terrorist financing bill, 2003

<sup>4</sup> Financial Action Task Force (FATF) on Money Laundering, The Forty Recommendations, 1996

<sup>5</sup> International Monetary Fund, The IMF and the Fight against Money Laundering and the Financing Of Terrorism, A Fact sheet, September 2004

*other words, the source of illegally obtained funds is obscured through a succession of transfers and deals in order that those same funds can eventually be made to appear as legitimate income".<sup>6</sup>*

### ***1.3 The Phases of Money laundering***

The objective of the “laundrymen” involved in a wide range of criminal activities is to hide the source of money and to convert the “dirty money” and “wash it” into a form that will be difficult to backtrack the origin, such as placing the “dirty money” in bank accounts, real estate, stocks, insurance premiums and other assets, which can be used later without raising suspicion.

The basic process of money laundering, that is globally accepted, has three stages: placement, layering and integration (this last phase can be divided into two sub-phases: justification and investment). Criminals use legal entity structures in the layering (moving, dispersing or concealing funds) and integration (reinvesting funds) stages of money laundering cycle. These legal entity structures such as companies, partnerships and trusts are used to support criminal enterprises, launder illicit funds, hide ultimate ownership behind layers of companies or trusts in multiple overseas jurisdictions, move and obscure the ultimate destination of funds, avoid tax, conceal wealth, and avoid detection and confiscation

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<sup>6</sup> Robinson J., *The laundrymen: inside the money laundering, the world third largest business*, 2013

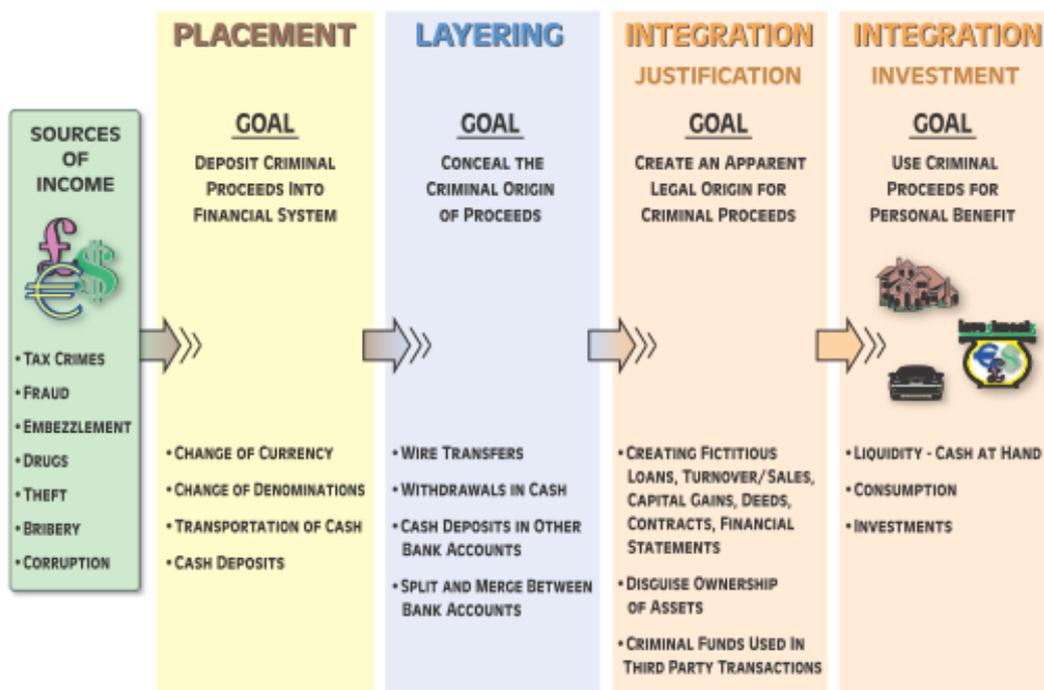


Figure 1 : Overview of money laundering taken from OECD report, 2009

### 1.3.1 Stage one: Placement

The Placement phase is the first step of the process, in other words it consists in the deposit and the allocation of the dirty money.

During this stage comes to light a crucial point of the all laundering process: the deposit of criminal proceeds into the financial system. Only with the allocation of criminal proceeds to one or more banks (that could have knowledge or not of the origin of money), the laundering will be reasonably achieved.

We can see that in this phase there has not been a proper “launder” of the criminal proceeds yet, because dirty money are only physically allocated into the financial system.

Now we can describe many ways of allocation of dirty money.

### 1.3.1.1 Smurfing

This method consists in simple operations with the moneychangers or breaking up a transaction involving a large amount of money into smaller transactions of an amount of money that has to be lower to the maximum amount established by the law of each Country (usually we talk about amount equal or lower to 10.000 €), because below that amount there is no need of fiscal control. In Italy the reporting threshold is fixed to 1.000€ (according to the Legge di Stabilità of 2015; according to the new Legge di Stabilità of 2016 that hasn't become law yet the threshold is change from 1.000 € to 3.000 € , except for the money transfer that remain to 1.000€)<sup>7</sup>.

The small size of the transactions and the numbers of transactions themselves make this procedure very intricate and not so fast as many people thinks. We have to say that it's true the fact that if the transactions are below the reporting threshold, the laundrymen can evade scrutiny from government agencies but the periodicity of the transactions (accomplished over and over again in a small period of time) can be classify as suspect.

So in order to efficiently work , the laundrymen needs a group of people (called *smurfs*) who, each of them, make multiple deposits into multiple accounts (often using aliases) at any number of financial institutions, in this way money enters in the financial system and then is available for layering. Suspicion is often avoided as it is difficult to detect any connection between smurfs, deposits and accounts.

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<sup>7</sup> Legge di Stabilità 2016 <http://www.gazzettaufficiale.it/eli/id/2015/12/30/15G00222/sg>

## STRUCTURING "SMURFING"

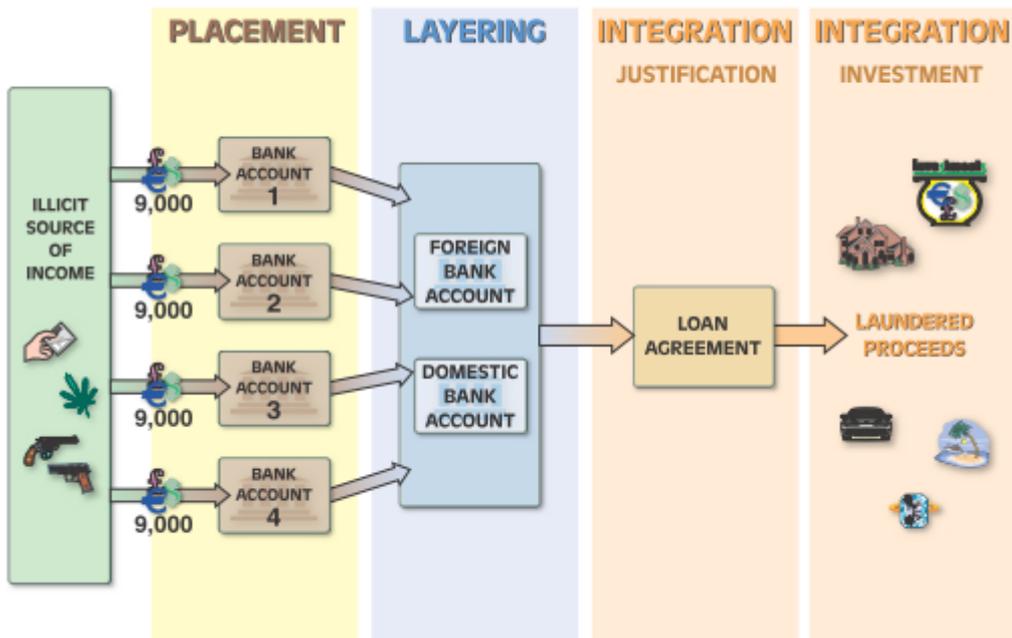


Figure 2: From OECD, "Money Laundering Awareness"

In this picture illicit funds are "smurfed" into domestic bank accounts in amounts below the threshold (that in Italy is 1.000 €) where the bank would make a report for unusual or suspicious transaction.

From there the money is transferred to off-shore bank accounts where the funds are used to make a "loan" to the criminal. All these acts can be committed by the criminal or by a third-party domestically and/or abroad.

### 1.3.1.2 Currency smuggling

Although the increasing prevalence of non-cash payment methods in developed economies, cash remains an important means of settlement across the world, with an estimated U.S. \$4 trillion in circulation and between 46% and 82% of all transactions in all countries being conducted in cash<sup>8</sup>.

Cash is widely used in criminal economy and it remains the raw material of the most criminal activity. In many cases, even when the proceeds of a crime are initially generated in electronic

<sup>8</sup> FATF report; "Money Laundering through the Physical Transportation of Cash", October 2015

form, criminals choose to withdraw the funds from bank account in cash, transport it in another country and pay it into another account in order to conceal their way and break the audit trail.

It is the bulk smuggling of cash and can be accomplished by hiding cash or its equivalent on your person (including in clothing like a coat or wallet), in suitcase, in a backpack, in a car, in a cargo or any other “container” whether worn or carried out by a person transporting the cash. Once the cash has been moved to its destination and used for its intended purpose it will eventually enter in the legitimate financial system and will be recycled by banks and other financial institutions.

The physical transportation of cash across an international border is one of the most basic forms of money laundering that is still practiced today. There are no fully reliable estimates for the amount of cash laundered in this way, but it figures out that it would seem to be between hundreds of billions US dollars per year. This method is so widespread because of the legitimate demand of cash. Because of that, many countries have reasonable knowledge and understanding of transportation of cash by natural persons and have comprehensive measures in place to monitor and control this issue. Many jurisdictions focus their attention to the transportation of cash by natural person rather than the transportation of cash by cargo and mail despite the amount moved in cargo being much larger than those being moved by natural person, this is because when transported in cargo cash is treated as a form of goods and in most cases only a basic customs declaration is required (most of countries do not require a specific cash declaration in addition to the normal custom declaration and the amount of detail required by this declaration is minimal, not even the actual value of the cash is required) ; this means that there will be not sufficient information available to custom to understand if the shipment is suspicious or not. The cash has moved from one country to another one, and in most cases the final destinations of the cash are the tax heavens (or offshore financial centers) where the AML (Anti Money Laundering) standards are very low. Once the amount of illicit cash is in the offshore financial centers, this could be transferred again to the country of origin.

A critical point of the smuggling is the actual weight of the cash that makes the carriage of it very difficult. This problem is the reason why most of the operations are realized using Euro currency and not, for example, using Dollar or Pound.

The Euro, in fact, is one of the few currencies that has the 500 bill (the corresponding bill of Dollar was abolished in 1934)<sup>9</sup>.

### *1.3.1.3 Gambling and Casinos*

The Casinos can be used at first and at third stage of money laundering process. Casinos utilize various instruments to facilitate gambling for their customers. The type and use of these instruments differs between casinos and they are influenced by local regulation and casinos operating structures.

Casino chips are the most common casino value instruments; they are issued by casino and used as a form of cash in gaming transactions between the casino and players. Chips are round and marked with denomination and name of the casino and are negotiable within the casino, or in other cases, within casinos of the same group.

A launderer can clean illegal cash by converting it into chips at a casino, and then exchanging it back into cash to deposit at a bank and have a cheque from the casino that shows that the transaction is legitimate. This method can be made more sophisticated by using a chain of casinos where the chips that were purchased with illicit cash, are converted to credit and transferred to another jurisdiction in which the casino chain has an establishment; the credit is then converted into form of casino cheque at second casino.

Another method is that money launderers may purchase chips from other money launderers or not related casino customers with clean background. This is done at a price higher than the chips face value.

In some jurisdictions, casinos allow winning cheques to be payable in cash. High-value casino cheques payable in cash have been observed in a secondary circulation as bearer negotiable instruments and used as a payment for goods or for reinvestment in criminal ventures, such purchasing drugs. High value casino cheques may come from the called V.I.P. rooms, which can provide alternative remittance service between player's home jurisdictions and the casino VIP room.

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<sup>9</sup> Grasso P., *Soldi Sporchi*, Dalai Editore, 2011, pp. 149-150

Another technique is that the launderer can purchase in large number “casino gift certificates”; many cases have been detected of money launderers purchasing high value or huge number of low value casino gift certificates which can be redeemed by third parties. The certificates are then sold or given to other persons so to distance the money launderer from the illicit funds. The launderer can also use illicit funds to purchase casino reward cards from legitimate customers paying them a premium above the value of the reward<sup>10</sup>.

The casino is described as a highly cash intensive business, so the money that every day is moved into the casinos is of suspicious origin. Because of that who is interested in money laundering can make the next step investing into the business by buying the casino. The launderer can own a casino and claim the large amounts of cash held are profits from their casino.

This requires taxes to be paid but gives launderers a legal cover for their illegal activities<sup>11</sup>.

### ***1.3.2 Stage two: Layering***

The Layering stage is the most complex and structured step of the money laundering cycle because its goal is the concealment of the criminal origin of the proceeds; so in order to do that, money has to be transferred and split frequently between bank accounts, countries, individuals and/or corporations. Money can be withdrawn in cash and deposited into bank accounts with other bank. It is usual to use bank accounts in countries with strict bank secrecy law and to nominate offshore corporations as the bank of account holders.

This stage requires high financial competence skills to realize the laundering operations in order to make more difficult for the government Authority discover the illegal operations.

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<sup>10</sup> FATF Report, “Vulnerabilities of Casinos and Gaming Sector”, 2009

<sup>11</sup> prof. dr. Unger B., drs. Siegel M., Ferwerda J., BSc Wouter de Kruijf, BSc drs. Busuioic M., Kristen Wokke K., “The amount of money and the Effects of money laundering”, February 2006

### *1.3.2.1 Correspondent bank*

Correspondent banking relationships are a useful means for banks to extend their services beyond the jurisdictions they operate in, by using a foreign bank as a substitute. But this indirectness could hide concealment of money laundering.

Correspondent bank relationships are agreements for one bank to provide services for another one in jurisdictions where the first bank has no physical presence and establishment.

It is basically a customer-supply relationship: the respondent bank is the customer and the correspondent bank is the provider of services. The relationship allows the respondent bank to move money by the correspondent bank's accounts so it can offer to its customers a range of services, in countries where it doesn't normally operate, this including cash management (for example, interest bearing accounts in a variety of currencies), international wire transfers of funds, cheque clearing, payable-through accounts and foreign exchange services.

There are inherent risks in the relationship because in many of these transactions the correspondent bank has no direct contact with the customer's entity, so the correspondent bank provides services for individuals or entities for which it has neither verified the identities nor obtained first-hand knowledge of the respondent's customer so it has to rely on the respondent bank's having performed all of the necessary due diligence and continuous monitoring of its customers' account activity.

A money launderer doesn't have to create its own shell bank to take advantage of correspondent banking; they can use an existing bank because it's all about concealment: the money is transmitted via respondent bank's account so it doesn't find the personal name account (so the source of money) and that is the key thing<sup>12</sup>.

As a consequence the many security policies imposed to the banks, as the customer's knowledge or the supervision of the operations, come to fail in the moment when for the correspondent bank became inevitably hard to verify the customer's integrity. As a solution there have been implemented many due diligence processes inside the bank.

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<sup>12</sup> prof. dr.Unger B., drs. Siegel M., Ferwerda J., BSc Wouter de Kruijf, BSc drs. Busuioic M., Wokke K., "The amount of money and the Effects of money laundering", February 2006

Financial institutions should be required, in relation to cross-border correspondent banking and other similar relationships, in addition to performing normal customer due diligence measures, to gather more information about the respondent institution to understand the completely the nature of the respondent's business and about the quality of supervision of the respondent bank, including whether it has been subject to a money laundering or terrorist financing investigation or regulatory action.<sup>13</sup>

Today thanks to the new control policies it is more difficult to create a correspondent bank relationships for money laundering purposes rather than the past.

Shell banks, certain offshore financial institutions and banks from non-cooperative countries and territories (NCCTs) are particular risk to legitimate correspondent banking relationships for illicit purposes.

These Countries have been analyzed by the FATF (Financial Action Task Force) and grouped into a Blacklist, where we can find many known tax heavens as for example Cayman Islands, Bahamas, Cook Islands, Panama, Philippines<sup>14</sup>.

### *1.3.2.2 Informal Value Transfer System*

The recourse to Informal Value Transfer System represent one of the oldest and most utilized technique to transfer money and services from one country to another foreign country without actually moving goods or cash.

Nowadays, there are a few business men that use this technique in a legitimate way: this method is used mostly by people related to racketeering, tax evaders, criminal organization financed by government and money laundering.

An informal value transfer system refers to any system, mechanism, or network of people that receives money for the purpose of making the funds or an equivalent value payable to a third party in another geographic location, whether or not in the same form. The transfers generally take place outside of the conventional banking system through non-bank financial institutions or other business entities whose primary business activity may not be the transmission of

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<sup>13</sup> FATF, The FATF recommendations, Correspondent banking, 2012, p. 16.

<sup>14</sup> FATF, Annual review of Non-Cooperative Countries and Territories, 2007, p. 14

money. The systems were established originally on the Indian subcontinent in Asia as a means of settling accounts within villages.

Depending on the ethnic group and on geographic area, Informal Value Transfer System are called by a variety of names including, for example, “Hawala” (Middle East, Afghanistan, Pakistan); “Hundi” (India); “Fei Ch’ien” (China); “Phoe Kuan” (Thailand); and “Black Market Peso Exchange” (South America). Between them, Hawala deserves a deeper analysis<sup>15</sup>.

Today Hawala is probably used mostly for migrant workers’ remittances to their countries of origin. Let’s spend some words about how Hawala works.

In the most basic variant of hawala system, money is transferred via a network of hawala brokers. It is the transfer of money without moving it. For example , a customer A approaches a hawala broker in one city and gives an amount of money that is to be transferred to a recipient in another, usually, foreign city. Along with the money, he usually specifies something like a password that will lead to the money being paid out. The hawala broker X calls another hawala broker M in the recipient’s city and inform M about the agreed password, or gives other disposition instructions of the funds. Then the intended recipient B, who also has been informed by A about the password, now approaches M and tells him the agreed password. If the password is correct, then M releases the transferred amount to B, usually minus a small commission. X now basically owes M the money that M had paid out to B; so M has to trust X’s promise to settle the debt at a later date.

The singular feature of the system is that no promissory instruments are exchanged between the hawala brokers; the transaction is based entirely on the honor system. As the system does not depend on the legal enforceability of claims, it can operate even in the absence of legal and juridical environment. Trust and extensive use of connections such as family relations and regional affiliations, are the components that distinguish it from other remittance systems. Settlements of debts between hawala brokers can take a variety of forms, and don’t need to take the form of direct cash transactions. In addition to commissions, hawala brokers often earn their profits through bypassing official exchange rates; generally the funds enter the system in the source country’s currency and leave the system in the recipient country’s currency. A settlements often take place without any foreign exchange transactions, they can be made at other than official exchange rates.

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<sup>15</sup> United States Department of the Treasury Financial Crimes Enforcement Network, Financial advisory, March 2003 p.2-4

Hawala is attractive to customers because it provides a fast and convenient transfer of funds, usually with a lower commission than that it is charged by banks.

Its advantages are more evident when the receiving country applies unprofitable exchange rate regulations or when the banking system in the receiving country is less complex.

After the terrorist attack of 9/11, money laundering crackdowns, some government officials assert that hawala could be used to facilitate money laundering, avoid taxation and move wealth anonymously. As a result, hawala has declared illegal in U.S. states, India, Pakistan and some other countries.

After the 9/11 attacks, the American government suspected that some hawala brokers may have helped terrorist organizations to transfer money to fund their activities, but the 9/11 Commission Report showed that the bulk of the funds were instead sent by an official inter-bank wire transfer.

As a result of intense pressure from USA authorities to introduce a systematic anti-money laundering initiatives on global scale, a large numbers of hawala networks have been closed and a large number of hawala brokers have been persecuted for money laundering.

### ***1.3.3 Stage three: Integration***

The final step of the money laundering process is called the integration stage. It is when the money is returned to the criminal from what seem to be legitimate sources. Having been placed at the beginning as cash and layered through many financial transactions, the criminal proceeds are now fully integrated into the financial system and can be used for any purpose.

There are many different ways in which the laundered money can be integrated back with the criminal; however, the major objective at this stage is to reunite the money with the criminal in a manner that does not draw attention of the authorities and appears to result from a legitimate source. For example, the purchases of real estates, art work, jewelry, high value cars are common ways for the launderer to enjoy their illegal profits without necessarily drawing attention to themselves.

So the goal is to use criminal proceeds for personal benefit. Cash or electronic money can be used for safekeeping (cash on hand); consumption (day to day expenditures, lifestyle, jewelry,

vehicles, yachts, art); investing(bank accounts, real estate, stocks, securities, receivables, funding of legal and illegal business activities).

Criminals may want to display their wealth and wealthy lifestyle by acquiring “badges of wealth” such as luxury homes, vehicles, boats, jewelry, etc. Criminals will seek to launder the proceeds from their crimes to pay for these in order to avoid detection by the tax or law enforcement authorities.

Now we focus on the main end market for the new clean money.

### *1.3.3.1 Investment in capital markets*

The launderer can invest the clean money into financial assets so to avoid having huge amount of liquidity. The financial instruments made available by the bank, can be classified in 3 categories: bond, shares and derivatives.

The assets, such as bonds and shares, are generally low risk and so the chances of losing money are small; and they have the chance to be converted into liquidity immediately.

The derivatives can be purchased by the launderer in order to invest the cash in reputable enterprises. To do that, the launderer needs a disreputable broker. These assets are highly liquid and so can be easily be resold in order to return the cash back to the launderer. However derivatives are much more risky than the traditional financial instruments.

### *1.3.3.2 The gold market, the diamond market, purchase of luxury goods and real estate acquisitions*

For what concerns the investments in the real sector, the launderer has many ways to invest its new clean money; here there are some type of investments in real sector.

According to FATF, gold offers the advantage of having a high intrinsic value in relatively compact form. It can be bought and sold for currency with little difficulty in most areas of the world. It holds its value regardless of the form it takes, it is often sought after as a way of facilitating the transfer of wealth.

The advantages that gold provides, are highly attractive to the money launderer. These advantages are the high intrinsic value, convertibility and potential anonymity in transfers. With

regard to the use of the gold , we find two type of cases: the first and the simplest typology is when the money launderer or someone acting in his behalf simply purchase gold from a retail merchant with funds that were generated directly by an illegal activity; the second typology is when the gold itself may be the “proceeds” of the crime that needs to be laundered; in this case the launderer may attempt to hide the illicit nature of the gold by creating for example a system of false invoicing<sup>16</sup>.

Diamonds and other precious gems have some of the advantages as those provided by gold (high intrinsic value in compact form). Diamonds can be traded with little difficulty world-wide. The large scale of production of raw diamonds is limited to a few areas of the world ( South Africa, Western Africa, Australia, to name just a few of these) and high-volume trading is centered in few location; so for these reason not every country will have the same level or type of diamond trading activity. The ease with which diamonds can be hidden and transported and the very high value per gram for some stones make diamonds particularly vulnerable to illegal diversion from the legitimate channels for the exploitation and profit of criminals. As for gold, the simplest typology involving diamonds consist of direct purchase of diamonds with criminal proceeds.

The gold trade and the diamond industry are two sectors that appear to show considerable vulnerability to being exploited for money laundering. The high intrinsic worth and their compact nature appear to make the gold and diamond attractive sectors as a cover for laundering illegal funds from other crimes as well as a laundering vehicle in and of itself<sup>17</sup>.

The launderer also will invest in consumer goods such televisions, kitchen appliances, and so on, because such purchases can be easily transported across borders without arousing suspicions. These goods can be sold abroad and produce what appear to be legitimate commercial revenues.

The similar logic is followed in case of the purchase of luxury goods. These goods can be kept for personal use or sold for export. One of the qualities of these products, which make them attractive is the fact that large amounts of cash can be transformed into a less conspicuous form. It is not unusual for purchasers of luxury goods to pay by cash and questions are unlikely to be asked as the salesman is not willing to upset the purchasers with personal questions.

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<sup>16</sup> FATF-GAFI, Report on money laundering typologies, 2002-2003, p. 19.

<sup>17</sup> FATF-GAFI, Report on money laundering typologies, 2002-2003, p. 24.

The launderer can also invest the illegal cash into property which is generally a non-depreciating asset. This would normally require a real estate agent who is willing to overlook the fact that the launderer wants to pay cash for an expensive assets. This assets can then be sold fairly easily to show a legitimate source of cash.

#### *1.3.3.3 Falsification of foreign trade prices*

Money laundering affects imports and exports in term of prices. One of the most common tactics used for laundering money and generating illegal capital is to overprice imports and to underprice exports<sup>18</sup>.

Overpricing the imports: an importer who wishes to buy a machinery for 1 million of dollars could request that the price be increased by 10 % so that upon the payment of 1.1 million dollars the extra 100.000 be placed into his private bank account in the exporter's country

Underpricing exports: an exporter of art works can sell her/his paintings to a foreign dealer for 50 % less than their negotiated value with the understanding that when the payment is made the extra 50 % be deposited into her foreign bank account in the dealer's country.

Money laundering activities can also bring about a distortion of a country's imports and exports. As mentioned above, money launderers tend to engage in (often imported) luxury consumption. As a consequence, there will be balance of payments problems. Such imports do not generated domestic economic activity or employment and can depress domestic prices, thus reducing the profitability of domestic enterprises. This appears to be particularly the case in developing countries<sup>19</sup>.

#### *1.3.3.4 Cash intensive Business*

This laundering method is common in situations where the launderer uses a legitimate, cash intensive business as a cover for laundering (such as an exchange business or a hotel to help justify large currency deposits).

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<sup>18</sup> Baker1999, p. 33

<sup>19</sup> prof. dr.Unger B., drs. Siegel M., Ferwerda J., BSc Wouter de Kruijf, BSc drs. Busuioic M., Wokke K., "The amount of money and the Effects of money laundering", February 2006, p. 86

The owner mixes the dirty money with the business's actual revenues, depositing them together into a single bank account. The deposit will not raise suspicions given the cash-intensive nature of the business and the fact that the launderer will over-report the actual revenues, so being able to justify the dirty proceeds.

Cash intensive businesses are businesses which have a high volume of legitimate cash flows.

Examples of such businesses can often be found in the restaurant, hotel, pub and club, taxi, building and construction, entertainment, convenience store and motor vehicle retail sectors. Cash intensive businesses are used in all stages of the money laundering cycle.

Law enforcement operations have identified cash intensive businesses being used to launder proceeds from a range of serious and organized crime activity including drug and tobacco offences, tax evasion, tax and welfare fraud and illegal gambling.

Cash intensive businesses are used: to provide a front to launder money and expand criminal enterprises; reinvest criminal income in the legitimate economy (for example, the business is acquired using tainted money but operates legitimately); co-mingle illicit and legitimate income.

**1.4 The Black Market Peso Exchange**

The black market peso exchange arrangements is a particular money laundering strategy that combines several techniques that involve the misuse of both financial and international trade system. This method became subject of many studies in the eighty's when Colombia became the most dominant exporter of cocaine into the U.S. it was stated that these illegal drug sales

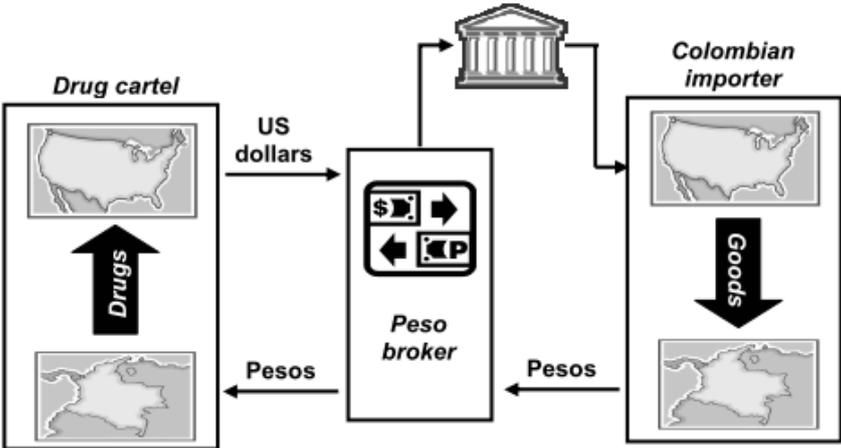


Figure 3 FATF, GAFI, Trade Based Money Laundering, 2006

had generated about \$10 billion a year for the Colombian drug cartels, which \$4 billion a year was laundered through the black market peso exchange arrangements.

The mechanism of this strategy is composed by many steps that we can take in consideration.

First the Colombian cartel smuggles the illegal drugs into the U.S. and sells them in exchange of U.S. dollars cash. As second step, the cartel arranges to sell the U.S. dollars at a discount to peso broker in exchange of Colombian pesos. The third step consists in that the peso broker pays the drug cartel with pesos from his bank account in Colombia (so from now the drug cartel is eliminated from any further involvement in the arrangement). As fourth step the peso broker “smurf” the U.S. dollars into the U.S. banking system to avoid reporting requirements and consolidates this money in his U.S. bank account. As fifth step the peso broker identifies a Colombian importer who needs U.S. dollars to purchase goods from U.S., so the peso broker offers him an exchange rate that generally is better than the one that Colombian banks offers. So as sixth step the peso broker arranges to pay the U.S. exporter (on behalf of the Colombian importer) from his bank account. After that the U.S. exporter ships the goods in Colombia. The last step is that the Colombian importer sells goods (that most of time are high value items like consumer electronics) so he gains peso with which he repays the peso broker<sup>20</sup>.

### ***1.5 The changed role of financial sector: new laundering techniques***

The primary concern of AML (Anti-Money Laundering) policy was laundering through the financial sector, especially the banking sector. As a consequence this sector became more regulated and controlled and increasingly aware of money laundering issues. Because of that and because of the increasing laundering costs, the banking sector has become less attractive for launderers.

Anyway, the financial regulation does not include the entire financial sector. Since the liberalization of capital markets in the 80's, higher incomes were created and finance became a world of its own with the creation of new financial instruments. In the last 30 years many new investments and new markets for these investments have been created, partly located within traditional banks recalled as “shadow banks”<sup>21</sup>. Securities and securitization, derivatives and

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<sup>20</sup> FATF, GAFI, Trade Based Money Laundering, 2006, p. 7

<sup>21</sup> Unger B., Water always finds its way: identifying new forms of money laundering, Springer, 2012.

over the counter derivatives, hedge funds, venture capital and private equity funds were some of these new prominent financial innovations. They offered large profits and were not fully under control of central bank and were largely out of government control.

The 2009 financial crisis revealed that criminals made use of the liquidity squeeze that resulted from the diffidence that people were having for the banks and interbank lending in that moment.

Criminals introduced additional cash and helped the dried out of banking sector.

According to the head of the UN'S Office on Drugs and Crime, Antonio Maria Costa, in early 2009 several hundred billions US dollars had been introduced into financial system by mafia<sup>22</sup>.

The bank of Italy also made claims regarding increased mafia involvement in lending as bank loans dried up, based on the evidence provided by the Central Bank's Financial Intelligence Unit, of a sharp increase suspicious financial transactions<sup>23</sup>.

The global financial crisis has generated political pressures for more regulation of banking sector, but it has also offered new ways of laundering funds.

Money laundering can take many forms. For example Al Capone used launderettes for disguising illegal alcohol revenues during the prohibition in the U.S.; launderettes (a flourishing cash intensive business in the 1930's) were an optimal location to slip the money from illegal alcohol sales into the cash register.

One of new forms of money laundering is the electronic payment forms money laundering, like the "e-cash". The E-cash is harder to trace than real cash as the ease with which it can flow around the world makes very hard for the authorities to pick up. Money becomes not a real commodity, but simply a line of piece of paper or a computer screen. The launderer then doesn't have to worry about depositing large amounts of cash as the money does not physically exist. All payments and receipts are made electronically.

Other new forms of laundering include prepaid virtual gold currencies, atm cards, mobile phone payments, etc. Virtual gold currencies (for example e-gold, Goldmoney, e-Bullion, Anonymous Gold) are account-based electronic payments system whose value is backed by 100%-golden deposits in private storage of the system provider who often operates from an off-shore country.

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<sup>22</sup> AML-CFT ,Financial crisis window for Mafia money laundering, [www.irs.gov/businesses/small/article/0,,id=154555,00.html](http://www.irs.gov/businesses/small/article/0,,id=154555,00.html), 30 December 2010.

<sup>23</sup> Bloomberg, L. P. ,Mafia Money—Laundering Profits Swell in Credit Crisis,[www.bloomberg.com/news/2010-07-21/bank-of-italy-says-financial-crisis-fosters-mafia-driven-money-laundering.html](http://www.bloomberg.com/news/2010-07-21/bank-of-italy-says-financial-crisis-fosters-mafia-driven-money-laundering.html), 30 December 2010

In the case of gold currencies, only a certain weights of gold are booked to the accounts of receivers. While the possession of gold reserves changes constantly, the gold in the treasury vault remains untouched. For exchange or purchase of gold currencies, the user opens an account for virtual gold currency at a system provider. The identification requirements are often limited only to a request for information such as name, email address and physical address to which a verification code is sent<sup>24</sup>.

Criminals can purchase legitimate prepaid Automated Teller Machine (ATM) cards or smart cards, deposit their dirty money onto the card, and then withdraw the newly-cleaned funds from any ATM anywhere in the world. Mobile phone payments are popular methods for making transactions in the Middle East, provide money launderers an opportunity to evade AML agencies.

### ***1.6 Bitcoin***

Bitcoin is the most popular, decentralized virtual currency in the world. Businesses both large and small have begun to accept bitcoins as a legal form of payment. In addition, Bitcoin currency exchanges, which trade bitcoins for real currency, have quickly arisen because of the currency's growing popularity. At its core, Bitcoin is a peer-to-peer, decentralized network administered by the network's users, as opposed to a centralized network in which a single individual or group controls the network and issues currency to the users. In a decentralized network, no one owns the network, and so, no one has absolute control over the applicable currency.

But Bitcoin's evolution has been linked to criminality. The use of bitcoins for illicit purposes not only would facilitate criminal activity all through the world, but also would corrupt the security of individuals using bitcoins for legitimate purposes, like for example users who send remittances to family members abroad.

Understanding how Bitcoin works and so how criminals launder money using the Bitcoin network, requires knowledge of three concepts: the double spending problem; how someone conducts a Bitcoin transaction; the figure of the "miner" and the "mining" process.

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<sup>24</sup> Woda, K. (2006). Money laundering techniques with electronic payment systems. *Information & Security International Journal*, 18, 27–47

First, the double-spending problem is the biggest obstacle to create a viable virtual currency. It is the result of successfully spending some money more than once, so an individual double spends when he uses the same unit of currency in multiple transactions<sup>25</sup>. Bitcoin protects against double spending by verifying each transaction added to the blockchain to ensure that the inputs for transaction had not previously been spent.

About of how a Bitcoin transaction occurs we have to say that before a user can trade in Bitcoin, he/she must download a “wallet” application, which contain the “public key” and the “private key” that are composed of a series of numbers and letters. The public key represents the user’s public address, basically it serves as an identifying mark that user can post on Internet to engage in trade. The private key is like a sort of password that only the user knows and he may use it to “sign” transaction. To understand better how a transaction works let’s do an example: Mary wants to sell a pair of socks to Steve; first Mary tells Steve her public key that is her address; after Steve decides to buy the socks, he generates a transaction quantifying his bitcoin payment for the socks that everyone in Bitcoin network can see; he then signs the transaction with his unique private key; at the end the “miner”, that we call John in this example, verifies the transaction. But before verifying the transaction, John has to look to the “public ledger” to confirm that the transaction does not hide double spending. This public ledger serves as a publically available chronological list of all the past transactions in the network. So the transaction history of a single bitcoin can be traced in the public ledger by looking at every transaction signature accompanying each trade of bitcoin. In this way a bitcoin can be identified as a single chain of past, digital signatures recorded in the public ledger with each signature serving as a link in the chain. This chain of past signatures is exclusively applied to a single bitcoin because two bitcoins cannot share the same transaction history, so providing the unique signature the miners are able to understand if it has been double spending or not.

This system allows the decentralized network of Bitcoin to operate without third-party oversight (instead it happened for other real currencies).

As a consequence, this fact decreases transaction costs, increases Bitcoin liquidity, and provides the necessary safeguards to ensure consumer confidence.

It is too generic to say that Bitcoin is anonymous network, it is more correct to say that it is a pseudonymous one, because every transaction that appears in the public ledger includes the public key (so the address) of those involved in the specific transaction. So all bitcoin

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<sup>25</sup> From <https://en.bitcoin.it/wiki/Double-spending>

transactions are traceable. The public address cannot be traced directly to a person's identity but it is linked to an IP address that is the identifier assigned to all devices accessing the Internet (and by that you can trace and discover location and identity of the real person). Because of that some users employ an anonymizing software such the "Tor" (The Onion Router).

Software like Tor allows criminals to purchase bitcoins anonymously with dirty money. When a money launderer feels it is safe, he can use these bitcoins to buy goods or exchange them for money, without revealing his IP address. So anti-money-laundering laws for Bitcoin must bypass or eliminate anonymity in the network.

The last thing that we have to explain is the role of "miner". Miners verify transactions through the mining process; they group these transactions into blocks which miners add to the public ledger forming a compilation of recent transactions. This create a history of all bitcoin transactions because every block contains a reference point that identifies the immediately preceding block on the public ledger. To verify a block of transactions a miner must solve a complex math problem and generate a "proof of work" to everyone in the network upon completion of the problem; the solution of problems requires high skills, high powered PC components and powerful software. Miners compete to verify blocks, and more computing power a miner has, the greater the chance he has to verify a block first. As more miners enter in the system, the network automatically increase the difficulty of the math problems.

After a miner verifies a block of transactions, new bitocoins enter in circulation; miners receive these new bitcoins as a reward for update the public ledger with recent transaction. Although the maximum amount of bitcoins in circulation is capped at twenty-one million, the incentive to mine will likely remain after reaching the cap because parties are often willing to pay voluntary transaction fees in real currency to verify their transaction.

Someone might argue that although the mining process doesn't implicate money laundering, the reward transaction fees for miners, that verify potentially fraudulent transaction, might incentivize criminal behavior. An example of money laundering that occur during the mining process could be this one: a criminal miner Bob, and two other criminals, Matt and Joe, stage a transaction. Matt and Joe first enter into a ordinary transaction in which Matt gives Joe one bitcoin. Then Matt and Joe give to Bob a specific amount of bitcoins in transaction fees. Matt and Joe purchased these bitcoin with money acquired through criminal means, which must be laundered to avoid suspicions. Bob verifies the transaction along with other transaction made between non-criminal parties who provide to Bob transaction fees but, this time, with "clean

money”. At the end Bob returns to Matt and Joe the original amount in clean bitcoins received from the non-criminals parties so by allowing Matt and Joe to spend their criminal proceeds without fear of detection.

But we have to say that this scenario is hard to find in the reality and it is difficult to put in act.

We have to say that a criminal who wishes to launder money cannot select a “partner” miner to verify the fraudulent transaction. Instead many miners compete to verify the transaction. So in order to do that criminal miners must outperform other miners to verify criminal transaction, otherwise the criminal miner is unable to receive the transaction fees provided by his criminal parties.

The low probability of a criminal miner outperforming other miners for a single transaction discourage such activity, especially in light of increased competition from sophisticated mining companies<sup>26</sup>.

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<sup>26</sup> Singh K., the New Wild West: Preventing Money Laundering in the Bitcoin Network, 13 Nw. J. Tech. & Intell. Prop. 37 <http://scholarlycommons.law.northwestern.edu/njtip/vol13/iss1/2>

## ***CHAPTER 2***

### ***The role of companies in money laundering process***

We know from years that almost every economic crime involves the misapplication and abuse of companies. For example money launderers use multi-layered entity structures in the layering (moving, dispersing and disguising) and integration (reinvesting funds) phases of the money laundering cycles. Legal corporate vehicles such companies, partnerships, are used to hide ultimate ownership behind layers of companies or trust in multiple offshore jurisdictions, move and hide the ultimate destination of funds, avoid tax, conceal wealth, support criminal enterprises.

The issue of abuse of corporate entities for illicit purposes has drawn an increased attention from authorities and policy makers in the recent decade. While companies have been credited for their huge contribution for rising prosperity in market based economies there has been a growing concern that these corporate entities may be misused for illicit purposes such as money laundering, illicit tax practices, fraud, bribery and corruption. The growing concern is due to the fact that the misuse of corporate entities may lead (from a market integrity perspective) to a threat of financial stability.

It is extremely difficult to quantify with precision the extent of misapplication of corporate entities for criminal purpose. This chapter describes many types of corporate vehicles misused and how money launderers use this entities to laundry money.

#### ***2.1 Types of corporate vehicles misused***

Corporate vehicles are legal entities (that are legal persons of all types and various legal arrangements, trust for example), through which are conducted a variety of commercial activities and assets are held. Corporate vehicles (companies most of all) are the basis of most commercial and entrepreneurial activities in market-based economies. They have become an important and indispensable part of the modern global financial landscape and they have contributed hugely to the globalization that has occurred over the last half century. Today the

rapid flows of private capital, technology, good and services involve corporate vehicles at virtually every level.<sup>27</sup>

Despite the important and legitimate roles that corporate vehicles play in the global economy, these entities may be misused for illicit purpose under certain conditions. The use of these entities as a mean for illicit activities is potentially appealing for criminals because these vehicles may enable criminals to cloak their crimes behind the veil of separate legal entity. A report commissioned by the European Commission concluded that the ability of legal entities to effectively conceal the identity of their beneficial owners stimulates their use for criminal activities<sup>28</sup>.

The corporate vehicles can operate onshore jurisdiction and offshore jurisdiction; we need to give a greater focus on offshore jurisdiction for three reasons. First, some offshore jurisdictions provide excessive secrecy for their corporate vehicles and create suitable environment for their misuse for criminal purposes. Second, shell companies constitute a substantial portion of the corporate vehicles established in some offshore financial centers and they face a huge risk of being abused for illicit purposes. Third , a number of offshore jurisdictions protect anonymity by enacting strict bank and corporate secrecy laws that prohibit company registrars, financial institutions, lawyers, under the threat of civil and criminal sanctions , from disclosing any information regarding beneficial ownership and control to regulatory and law enforcement authorities. Some jurisdictions allow corporate vehicles that are established in their jurisdiction to employ instruments that can be used to obscure beneficial ownership and control ( for example bearer shares, nominee shareholders, nominee directors that permit to obscure the true owners and controllers).

Corporate vehicles such corporation, trusts, partnerships are often used together, each established in a different jurisdiction in order to maximize the anonymity and to not permit the authorities to discover the ultimate beneficial owner and controller.

### ***Corporations***

Corporation is the primary legal entity through which a business activity is carried out in most marked based economies; a corporation is a business or organization formed by a group of

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<sup>27</sup> OECD report, Behind The Corporate Veil: using corporate entities for illicit purpose, OECD, 2001

<sup>28</sup> T.M.C. Asser Institut, *Prevention of organised crime: The registration of legal persons and their directors and the international exchange of information* [commissioned by the European Commission (“Falcone programme”)], 1 March 2000, p. 11 (“2000 EC Legal Persons Report”)

people and it has rights and liabilities separate from those of the individual involved. In the eyes of the law a corporation has many of the same rights and responsibilities of a person. It may buy and sell and own a property; stipulate contracts and leases. It pays taxes. It can be persecuted and punished if it violates the law. But the main advantages of this vehicle is that it has an unlimited life (that goes beyond the lifetime of any member of founder) and it offers to its owners the protection of limited personal liability; this means that the shareholders may only lose the full amount of their investment so their personal assets will not be reachable by the corporation's creditors. The limited liability feature of a corporation has been widely recognized as a key of encouraging entrepreneurship and facilitating capital formation from a large base of investors. But due to its advantages (so separated legal personality and ability to obscure the identity of its true owners) the corporation can be used to facilitate criminal conduct and other illicit crimes.

We can distinguish many type of corporations, like for example private limited company and public limited company: the primary distinction between them is that the shares of a public limited company are freely transferable and there is no limit of the number of shareholders in a public limited company; because of such flexibility public limited companies are subject to a rigorous regulation and supervision, such a frequent and detailed financial disclosure and enhanced accountability. Instead private financial companies may only issue registered shares so must limit transfers of its shares and limit the number of shareholders and may not issue shares to the public at large; but in return private limited companies are subjected to a less restrictive policy and regulatory regime than the public limited companies. Because of that in European Union private limited companies have been frequently misused (and because of their lower minimum share capital requirement in respect to the public limited companies). Even public limited companies whose share are not traded on a stock exchange are also vulnerable to misuse for illicit purposes because, in many jurisdictions, they are permitted to issue bearer shares without being subject to the more stringent regulatory requirements imposed on public traded companies.

Another type of corporation are the international business companies (IBCs). They are the primary corporate forms employed in offshore financial centers by non-residents. They are limited liability companies incorporated in an offshore financial center and they can operate without any government requirement. On the condition that it does not business in its home jurisdiction, IBCs may hide its ownership, and have not to pay taxes. In many jurisdictions it is not required to keep books and records. Licensing fees from IBCs provide an important source

of revenues for many jurisdictions offering these vehicles. IBCs are used for many legitimate commercial activities, including holding intellectual property, engaging in international trading activities, serving as an holding company, but in most jurisdiction IBCs are not permitted to engage in banking, insurance, and other financial service. Given the fact that IBCs are not allowed to conduct any business activity within the jurisdiction of incorporation or with that jurisdiction's residents, the authorities in jurisdiction offering these vehicles may have less incentive to undertake rigorous monitoring. This fact makes these vehicles more mind to misuse for illicit purposes, including use of them as a shell companies to obscure the identity of the beneficial owners. IBCs are often used in money laundering schemes because they provide an impenetrable layer of protection around ownership of assets. They permit to conceal the origin and destination of goods in international commerce, to bypass arms control laws, and to evade taxes by moving profits and assets out of the reach of the tax collectors<sup>29</sup>.

### *Trust*

A trust is an important and legitimate vehicle for transfer and management assets. It provides an effective mechanism for managing assets given to minors, individual with handicap and others who has not experience in financial management. Trust could be also used to promote charitable purposes and for estate planning. In addition to personal and financing planning trust are often used to structure corporate transactions (such securitization programs) and employee benefits programs (such as pension schemes), international employee stock option plans, and compensation structures.

The trust is a vehicle that provides the separation of legal ownership from beneficial ownership. To establish it, the "settlor" (the trust creator) transfers the legal ownership of a property to a person or corporate entity called "the trustee". The trustee holds and manages the property in exchange of a provision of trust deed, for the benefit of the beneficiaries. To create a valid trust, the settlor is required to give up control of the assets that he has transferred to the trustee. In turn the trustee is obligated to observe the terms of the trust deed and has a fiduciary duty to act honestly and in good faith in best interest of the beneficiaries and, in the event there are no named beneficiaries, in the best interest of the trust.

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<sup>29</sup>Blum J., Levi M., Naylor T., Williams P., Financial Havens, Banking Secrecy and Money Laundering, United Nations Office drug control and Crime prevention, 1996

The advantage of the trust is that the owner of assets conveys the ownership irrevocably to the trust itself, and therefore prevents those assets from being seized by creditors.

Offshore trusts are usually protected by secrecy laws and may have additional level of concealment in the form of “flee clause” that permits (or compels) the trustee to shift domicile of the trust whenever the trust is threatened. The disadvantage is the normal loss of control by the owner (in theory the deed of trust is irrevocable, the former owner can influence, but cannot control the actions of the trustee).<sup>30</sup>

The use of this type of legal arrangements can play an important role in money laundering. Under certain conditions the trust can conceal the identity of the true beneficiary in addition to the source and the destination of the money.

We have to say that some conditions and the structure of some trusts allow them to be misused: some trust may exist without the need for a written document constituting them; there may be no obligation to register decision regarding the management of the trust, and it may not be possible to disclose them in writing to anyone; in some type of trust like for example discretionary trusts, the beneficiary may be named or changed any time, which make it possible to safeguard the identity of the beneficiary every time until the moment that the ownership of the assets is transferred; trust may be set up to manage company’s shares, and they make it more difficult to determine the identities of the true beneficiaries of the assets managed by the trust; certain legislation may expressly prohibit the freezing, seizure or attachment of the assets held in trust<sup>31</sup>.

These conditions may create a significant obstacle for the authorities that apply anti money laundering procedures, especially in relation to international operations, because these conditions would significantly slow the process of collecting information and evidence regarding the very existence of the trust and identifying its ultimate beneficiary. Part of the attractiveness of misusing trusts lies in the fact that trusts enjoy a greater degree of privacy and autonomy than the other corporate vehicles. Given the private nature of trusts and the fact that a trust is essentially a contractual agreement between two private persons, virtually all jurisdictions recognizing the trust have chosen to not regulate trust like other corporate vehicles like corporations.

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<sup>30</sup> OECD report, Behind The Corporate Veil: using corporate entities for illicit purpose, OECD, 2001, p. 25

<sup>31</sup> FATF-GAFI, Money laundering & terrorist financing through the real estate sector, FATF, OECD, 2007, p.13

## *Shell Companies*

A shell company is a company that is formed but which has no significant assets or operations, so it is a legal person that has no activities or operations in the jurisdiction where it is registered. These are businesses without substance or commercial purpose and incorporated to conceal the true beneficial ownership of business accounts and assets owned. Shell companies may be set up in many jurisdictions, including in certain offshore centers that are known for strong bank secrecy laws or for clement enforcement of money laundering statutes.

Shell companies are an integral part of money laundering process. For example, a person may set up a false business by obtaining the necessary and proper documentation to open a bank account in the business name. The dirty money is then put into the bank account, making it seem as if it was obtained legitimately. A person may open various accounts across for example the U.S. or overseas and use the shell companies as a means to shield their true identities. Since states do not require certain ownership information, it is extremely hard for law enforcement officials to trace the money back to the original creator of the shell entity. The Immigration and Custom Enforcement (ICE) of U.S. reports an example that a Nevada-based corporation received 3744 suspicious wire transfers totaling 81\$ million over a period of two years. However the case was not persecuted because ICE could not identify the beneficial owner of the corporation. The ICE has encountered a number of investigations in which shell companies have been established in the U.S. by international people. So many cases were closed due to the lack of information needed to investigate further.<sup>32</sup>

There are many money laundering methods that imply the use of the shell companies. One of them is the loan-back system; another one is the double invoicing. With the loan back the criminal puts the funds in an offshore entity that he owns and then loans them back to himself. This type of methods involving corporate vehicles will be discussed in the next paragraph.

### ***2.2 How launder money using corporate vehicles***

The basis of money laundering is that people who commits crimes need to disguise the origin of their criminal money so that they can protect it from seizure and use it more easily. In order to do that money laundering schemes frequently involve the means of corporate vehicles used in onshore and offshore jurisdictions. For example, gains from criminal activities in an onshore

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<sup>32</sup> Kinner M., Collage S., Vona L., Shell Companies, p. 8

jurisdiction can be transferred first to an offshore bank account opened in the name of an offshore financial center established corporation. These gains then will be moved through various jurisdictions always using corporate vehicles, to distance them from their illicit origins. At the end, a domestic company is established to borrow money back from the offshore entity. To accomplish greater legitimacy and to reduce the risk of alarming the financial authorities, money launderers seek to employ existing companies that have been established banking relationships with overseas financial institutions. These businesses give a credible evidences for their deposit levels and cross-border funds transfers.

Corporate vehicles can also be misapply to hide shield assets from creditors and other claimants like tax authorities, partner, and successors. The concealment provided by certain type of corporate vehicles can be achieved to obscure the existence or ownership of assets in order to keep them out of the reach of creditors and other claimants. In many cases of bankruptcy, funds have been diverted of one jurisdiction through shell companies and trusts incorporated in other jurisdictions where it is extremely difficult to trace beneficial ownership.

Many schemes and methods can be designed to fulfil illicit tax practices. For example, a taxpayer who is wishing to redirect income from his domestic business, could establish a company in foreign jurisdiction to issue false invoices to the tax payer's domestic business. The taxpayer would record and report the payments made in accordance with the fake invoices as expenses, all of that to lowering the reported business profit and so the taxes that he has to paid to the authorities.

One method that involves the use of a company is one of the most common method of money laundering: the loan back.

### ***Loan Back***

Loan structures are hugely used to launder illicit profit by disguising the criminal origin of the fund. A structure with loans is simple and no so expensive to set up. The loan back transaction is the commonest known form of money laundering by means of a loan. With this arrangement the criminal borrows his/hers dirty money back without being visible to the outsider. In other words the person borrows his/hers own criminal funds, directly or indirectly, without other people noticing. This allows the money launderer to deceive authorities and launder the funds. Illicit money is transferred to a company in another country. Then they're deposited in small amount into bank accounts of a foreign companies that are chosen in countries where there are

more strictly bank secrecy laws. After that, the money launderer receives a loan from the foreign company to open a company in the home country. So with this method the money that is earned illegally is placed into the system, layered and then integrated to make it appear legal.

The picture below is an example of loan back structure.

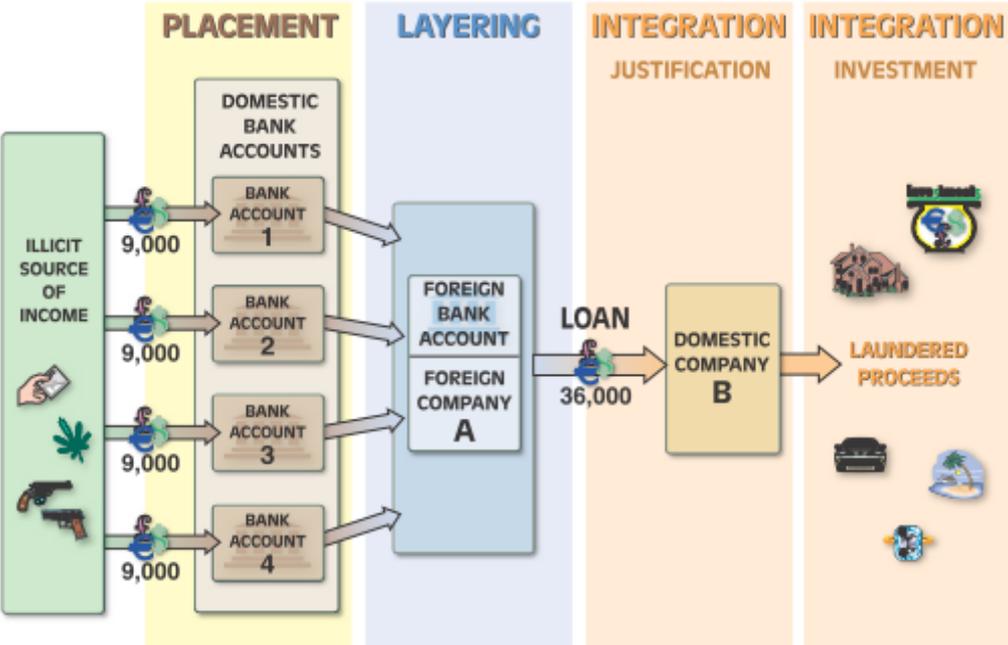


Figure 4: from "Money Laundering Awareness Handbook for Tax Examiners and Tax Auditors, OECD, 2009

Another type of loan could be used for money laundering purposes, the back-to-back loan<sup>33</sup>. In this case, a financial institution lends money based on the existence of a collateral posted by the borrower in the usual way. The collateral presented by the individual to the financial institution originates from criminal and terrorist activities.

**Trade Based Money Laundering**

It is defined as the “process of disguising the proceeds of crime and moving value through the use of the trade transactions in an attempt to legitimize their illicit origins”. This purpose can be achieved through the misrepresentation of the price, quality and quantity of imports and/or exports. Trade based money laundering has become an increasingly more attractive method by which criminal organizations move money for the purpose of disguising its origins and integrating proceeds derived from illegal activities into the worldwide economy.

<sup>33</sup> TPA, OECD, Money Laundering Awareness Handbook for Tax Examiners and Tax Auditors,2009, p.44

There are substantial evidences, reported by many committees worldwide such the Australian Institute of Criminology, the Financial Action Task Force (FATF) and Immigration and Customs Enforcement (ICE), that a primary method of trade based money laundering is directly linked to falsely invoicing goods traded among various countries<sup>34</sup>.

Trade based money laundering is characterized by many techniques which the basic and most common are: the over and under invoicing of goods and services; the multiple invoicing of goods and services; false description of goods and services. We'd like to spend some words for each of these methods.

***Over and under invoicing of goods and services***

It is one of the oldest methods of fraudulently transferring value across borders, the most important factor in this technique is the distortion of the price of the goods or services in order to transfer additional value between the importer and exporter. By invoicing the product at a price below the fair market price (the under invoicing), the exporter can transfer value to the importer, as the payment for the product will be lower than the value that the importer receives when he/her sold the products to the open market. It can be also another case in which there is the invoicing of the product at a price above the fair market price (the over invoicing), the exporter is able to receive value from the importer, as the payment of the products is higher than the value that the importer will receive when the products are sold to the open market.

Below we show an example of under invoicing.



Figure 5 FATF, Trade based money laundering report, 2006

<sup>34</sup> Mauro J. S., The New Economy in Financial Crimes, ACAMS, p. 1

This example shows two companies: Company A, the exporter of the foreign country and Company B, the importer of the domestic country. Company A sends 1 million products worth \$2 each, but invoices Company B for \$1 million products at a price of \$1 each. After that Company B sells the products on the open market at their fair price gaining \$2 million. Then Company B deposits the extra \$1 million (that it is the difference between the invoiced price and the fair market value) into a bank account to pay out according to Company A instructions.

It is worth to highlight some points after this example. This type of situation in which a company (A) sends products valued \$2 each but invoices them for \$1 each and so it loses \$1 million shipment, would not have sense unless the exporter and importer are partner in the fraudulent transaction. We could say even that Company A and Company B are controlled by the same entity; there is nothing that precludes a parent company from set up a foreign subsidiary in a jurisdiction with less strict money laundering controls , and sell products to the other subsidiary at a fair market price. Third point: we have to reflect about the tax implications due to under and over invoicing: an exporter that for example over-invoices the value of goods that ships could increase the value of tax credit that he would receive; in the same way an importer that is under-invoiced for the value of products that he receives may be able to reduce the value of import duties that he pays.

Instead than issuing one invoice, the launderer can issue more than one for the same international trade transaction. By invoicing the same good or service more than once, a money launderer is able to justify multiple payments for the same shipment of products. The level of complexity to achieve the laundering can be further increase by employing different financial institutions to make these additional payments. All this method is called multiple invoicing of goods and services.

In addition to change the prices of products imported and exported, the money launderer can overstate or understate the quantity of products shipped. It could be even the extreme case in which an exporter may not ships any products at all, but simply conspire with the importer to ensure that all shipping and custom documents associated to the fake shipment are processed.

### *False description of the products*

The money launderer can also falsifies the quality and type of good and services shipped. Let's do an example:



Figure 6 FATF, *Trade based money laundering report*, OECD, 2006

The example above describes an international shipment between two companies: Company I that is the domestic exporter and Company J that is the foreign importer. I ships \$1 million of gold products valued \$3 each to J, but invoices J for \$1 million silver product valued \$2 each. J pays I for the goods by sending a transfer of \$2 million. After that J sells the gold product to the open market gaining \$3 million. The extra profit of \$1 million (calculated by the difference between the invoice value and the actual value) is deposited into a bank account in according to I's instructions. All this process cannot be accomplished unless both I and J are colluding in fraudulent transaction<sup>35</sup>.

### *2.3 Warning signs of money laundering in companies*

Because money launderers are always developing new methods to achieve their purposes, no list of examples can be fully comprehensive, anyway we can present some key factors that if they take place in a company, and maybe they'll give you a cause of concern or basis for suspicions of money laundering.

#### *Non transparent ownership*

When shareholder relationships are transparent, the true beneficial owner is visible and he will proclaims their shares and income earned from business on their income tax return. If there is

<sup>35</sup> FATF, GAFI, *Trade based money laundering*, OECD, 2006, p. 7

a lack of transparency of the ownership, the identity of the true and actual beneficial owner is hidden. The lack of transparency in a shareholder relationships is an indicator for concealment of assets with a criminal origin. To accomplish this purpose the money launderer can use many instruments.

First, he can use bearer shares. They are negotiable instruments that accord ownership of a corporation to the person who possesses the bearer share certificate, so the person who physically is in possess of the bearer certificate holds to be the lawful shareholder of the corporation that issues such shares and he is entitled of the all rights referable to a shareholder. Bearer shares do not contain the name of the shareholder and are not registered (they are only registered with serial number). They are transferred by a delivery of share certificate, instead registered shares are transferred by written instrument. Bearer shares provide a great level of anonymity and easy transferability. Because of these features, they can effectively obscure ownership of a corporate vehicle, so they are vulnerable to misuse for illicit purposes by criminal persons. That's why bearer shares are permitted in many but not all jurisdictions. According to the OECD report today 46 countries permit the issuance of bearer shares and that 54 countries permit the issuance of bearer debt. A total of 38 of these countries have adopted mechanisms to identify the legal owners of bearer shares in some or all cases and 43 countries have adopted mechanisms to identify the owners of bearer debt instruments<sup>36</sup>.

Another instrument is the nominee directors and corporations serving as a directors. It can be misused to conceal the identity of beneficial owners. Nominee directors appear as a director on all company's documents and in official registries but pass on all duties required to be performed by a director to the beneficial owner of the company.

Money launderers often employ a chain of corporate vehicles, each established in different jurisdiction to maximize anonymity and make difficult for the authorities to trace back the beneficial ownership. For example an international business company in a jurisdiction A may be owned by another international business company established in another jurisdiction B, which in turn is owned by another and third international business company in the jurisdiction C. The last one can be owned by a trust established in another jurisdiction, and so on.

Last of all, we want to talk about intermediaries that are so important to accomplish money laundering purposes. They can be identify as company formation agents, lawyers, trustees and

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<sup>36</sup> OECD, Tax Co-operation, towards a level playing field, Assessment by the Global Forum on Taxation, 2008, p.16

other professional figures who have an important role in the formation and management of corporate vehicles in most offshore financial centers. Lawyers, notaries and others with professional confidentiality privileges are particularly attractive intermediaries because the identity of their clients can sometimes be protected from disclosure. In certain countries the law permit to lawyers and other seminal professionals the right to refuse to give evidence to the authorities about their client. Some offshore jurisdiction extend this privilege to management companies<sup>37</sup>.

***Purchase or sale of corporate shares at a price far above or below estimated value***

Criminal can also invest their money in legitimate companies because they want to earn a return on their criminal proceeds and to decrease their exposure to risk from other activities. A legitimate corporation could also be used for criminal activities and criminals attempt to launder money in the buying, financing and running of these legitimate companies. A suspicious indicator is the buying of the company's shares at a price far below estimated value, or net worth of the company. The balance of the actual price may be paid "under the table". Another indicator is the high amount of capital gains in respect to the span of time it was owned. This could mean that that gains are pumped up by the use of criminal proceeds at the time of the purchase.

***Increase in cash turnover***

After the examination of individual transactions, an auditor may discloses money laundering indicator as a significant increase in cash turnover/ sales.

In some situations the proceeds of a crime can be recorded as sales. Because the proceeds most of the time are cash, in many cases cash sales are fabricated so that clients and origin of the money cannot be discovered. The example below show this situation in a more clear vision:

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<sup>37</sup> OECD report, Behind The Corporate Veil: using corporate entities for illicit purpose, OECD, 2001, p. 29, 30

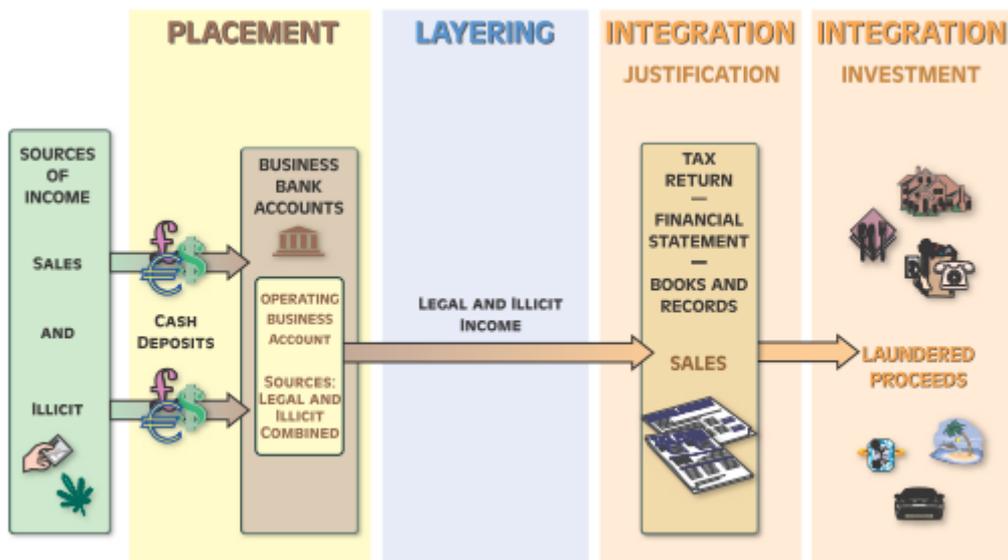


Figure6 from "Money laundering Awareness Handbook for Tax Examiners and Tax Auditors", OECD, 2006

This scheme represents what is happening when money launderer is depositing the criminal funds into the business bank account along with other funds generated from the normal sales. The illicit funds are recorded to the books and records as if the money came from the normal sales and the overstated income is reported in the tax returns. The company may have not pay the tax on this increased income if the company has trading losses available or if false deductions are also created<sup>38</sup>.

<sup>38</sup> OECD report, "Money laundering Awareness Handbook for Tax Examiners and Tax Auditors", OECD, 2006, p 29

## *Chapter 3*

### *Anti-Money laundering*

Money laundering can have negative macroeconomic consequences. Many of the effects of money laundering do not occur immediately or in the short run but pose long-term dangers for economy, societies and politics, especially in developing countries. The effects of money laundering and criminal connected activities can undermine country's financial stability and macroeconomic performance, resulting in welfare losses, draining resources from more productive economies activities, and so on. In an increasingly interconnected world, the negative effects of these activities are global, and their impact on the financial integrity and stability of countries is widely recognized<sup>39</sup>.

Due to the adverse macroeconomic consequences that money laundering can have, global organizations such as the International Monetary Fund and World Bank have promoted several initiatives to fight against money laundering and terrorist financing activities. These initiatives can be broadly attributed to four type of project goals.

- Raise awareness about negative impact of money laundering with the leaders of the countries and inform them about many resources that they can benefit to counter money laundering activities
- Develop an universal methodology for anti-money laundering
- Build an institutional capacity by organizing training conferences for specific anti-money laundering issues and delivering technical support to countries that want to establish or improve money laundering policies.
- Other activities such as keeping check on alternative remittance channels

The international nature of money laundering has led also to the creation of many global and regional regulatory bodies, to go up against this threat. The four major global anti-money laundering bodies that formulate guideline policies to combat money laundering activities worldwide are: the Financial Action Task Force (FATF), the International Money Laundering Information Network (IMoLIN), the United Nations Office of Drugs and Crime (UNODC), the Interpol. These organizations work on collaborative basis and share information; they share information on money laundering activities with global and regional financial institutions.

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<sup>39</sup> International Monetary Fund, The IMF and the Fight Against Money Laundering and the Financing of Terrorism, factsheet, September 2015

Additionally, the need to deal with the growing problems of international money laundering and related financial crimes has led to the emergence of certain specialized government agencies, generally referred to as Financial Intelligence Units (FIUs). The primary task of FIUs is to provide continuous exchange of information between financial services institutions, jurisdictions, and other prosecuting authorities. Most of FIUs across the globe are now a part of Egmont Group, which is an informal international gathering of FIUs, wherein the member FIUs regularly meet to find ways to increase internal cooperation and areas of information exchange, training and expertise sharing<sup>40</sup>.

### ***3.1 International Regulation***

#### ***3.1.1 The Financial Action Task Force***

The financial Action Task Force was established by during the 1989 G7 Summit in Paris to fight against the growing problem of money laundering; it is an intergovernmental organization that develops policies to combat money laundering. Currently it consists of 35 member countries jurisdiction and two regional organizations, the European Commission and Gulf Co-operation Council. "The objectives of the FATF are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system"<sup>41</sup>. The FATF has developed a series of recommendations that explain standard measures that countries members has to adopt if they want to combat money laundering. Each country member has to adapt its regulation to these standard measures according to the recommended procedures and with the implementation of actions and controls compatible to the circumstances of each reality. Because each country has different legal system, it is impossible to adopt the same measures with the same procedures in each country. The FATF Recommendations, therefore, set out the essential measures that countries should have in place to:

- Identify the risk, and develop policies and domestic coordination;
- Pursue money laundering, terrorist financing and the financing of proliferation;
- Apply preventive measures for the financial sector and other designated sectors;

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<sup>40</sup> Capgemini, *The Growing Threat of Money Laundering*, 2011, p.15-17

<sup>41</sup> From <http://www.fatf-gafi.org/about>

- Establish powers and responsibilities for the competent authorities and other institutional measures;
- Enhance the transparency and availability of beneficial ownership information of legal persons and arrangements;
- Facilitate international cooperation<sup>42</sup>.

The recommendations were drawn up in 1990 as initiative to combat the misuse of financial system. After 1990 they were constantly revised to reflect the evolving of money laundering methods and technique. After the 2001 9/11 events the FATF expanded its mandate to deal with issue of the funding of terrorist acts and terrorist organizations, so it created the Eight Special Recommendations on Terrorist Financing. Another revision happened for updating in 2003 when the FATF Recommendations together with the Eight Special Recommendations have been endorsed by 180 countries and were universally recognized as international standards for anti-money laundering. Lastly, in the 2012 the Recommendations were revised again for updating in collaboration with the FATF-Style Regional Bodies and the observer organizations (International Monetary Funds, the World Bank and United Nations). This has been done to ensure that the international standards remain up to date and relevant, so they are intended to be of universal application. In addition to the presentation of the annual report, the FATF puts in place a double evaluation of the actual implementation of the FATF Recommendations. It is a double evaluation because it consist in a self-evaluation (implemented by each country member through a yearly compilation of a standard questionnaire) and in a mutual evaluation. The latter consists of inspections realized by FATF examiners, and, based on the results of this inspections, a report has been drawn up with the evaluation of the grade of implementation of the Recommendations.

Another activity that FATF has done is about the periodic distribution of information about the Non-Cooperative Countries and Territories (NCCT). In the first report of February 2000, the so called “black list” was composed by 15 countries; then year after year the list has been reduced. Blacklist means all the countries which the FATF perceived to be non-cooperative in the global fight against money laundering and terrorist financing. Currently the FATF has drawn up a “whitelist” that represents all the countries that are helpful to share a minimum amount of information.

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<sup>42</sup> The FATF Reccomendetions,2012

The FATF standards have also been revised to fortify the requirements for higher risk situations, and to allow countries to take a more focused approach in areas where high risk remain or implementation could be enhanced. The framework of the FATF is founded on the “risk-based approach”. Countries should first identify, assess and understand the risk of money laundering that they face, and only then adopt appropriate measures to mitigate the risk. This approach allows the countries to adopt a more flexible set of measures, in order to target their resources more effectively and apply preventive measures that are commiserate to the nature of the risk, in order to focus their efforts in the most effective way<sup>43</sup>.

### ***3.1.2 EU Regulation***

It is important to signal three different European Directive, which incorporate most of the FATF Recommendations. The first Directive, in chronological order, is the n.91/308/CEE of the June of 1991, and it was on prevention of the use of the financial system for the purpose of money laundering; it was address especially to the banks and credit and financial institutions. For the first time there was a policy framework focused to identify subjects that could be involved in illicit operation of money laundering. Ten years later there was the second Directive ( 2001/97/CE) of the December of 2001 that extended the scope of the first Directive to the freelance professional figures. The third Directive (2005/60/CE), endorsed on October 2005, has almost completely cancelled the first Directive, and also has introduced a new approach to prevent and fight money laundering, based on the active collaboration of banks, insurances, and professionals on preventing money laundering<sup>44</sup>.

#### *EU Directive 91/308/CEE of June 1991 (First Directive)*

As already said before, this first Directive expressed the willingness of EU to contrast money laundering, in particular meaning of drug traffic. The text of the Directive is a model, a framework of which the State Members has to conform to when they draw up their national law. We can understand that by reading art. 15 that stated: “The Member States may adopt or retain in force stricter provisions in the field covered by this Directive to prevent money laundering”.

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<sup>43</sup> The FATF Reccomendations,2012

<sup>44</sup> Ranieri R., *Antiriciclaggio, verso la quarta direttiva*, Aziendabanca, Settembre 2014

This provision intended to safeguard and preserve financial and credit institutions from the danger of being involved as means in money laundering operations, without any restrictions to the free movement of capital. The mandatory compliances were referred to a clear number of subjects, and had planned very accurate examinations of the transactions which were considered particular risky by the financial institutions. The started point of the analysis was the identification of customers of financial institutions. The compliance ensured “that credit and financial institutions keep the following for use as evidence in any investigation into money laundering: in the case of identification, a copy or the references of the evidence required, for a period of at least five years after the relationship with their customer has ended; in the case of transactions, the supporting evidence and records, consisting of the original documents or copies admissible in court proceedings under the applicable national legislation for a period of at least five years following execution of the transactions”.

The next compliance, imposed to credit and financial institutions, was to examine with special attention any transaction which financial and credit institution considered to be related to money laundering.

The purpose of the first Directive was manly to delineate a set of crimes, facts that were prerequisites for money laundering, so to draw up a general guideline with the obligation of signal for suspected operations. The active collaboration was an important precept for the Directive. It consisted in the spontaneously communication to the national competent Anti-money laundering Authorities, of any facts that could be suspect or evidence of money laundering. The collaboration was at international level too, in the mean of carry out a fight against global money laundering in co-operation with other countries State Members. To summarize this Directive we can say that it was related on prevention of the use of the financial system for the purpose of laundering proceeds originated from illegal activities; the subjects of this Directive were manly credit and financial institutions that had to observe some rules like: the identification of the customer; the registration of suspected data and transactions; to inform the competent authorities of any fact which might be an indication of money laundering.

#### *EU Directive 2001/97/EC of December 2001 (Second Directive)*

It was issued 10 years after the release of the first Directive; the reason of issuing a new Directive was the need to increase the group of crimes and facts that were prerequisite of money laundering and to expand the field of application to non-financial sectors that were risky of

misuse for illicit activities. New money laundering methods were developing in that period, so this took to increase the category of subjects who the first Directive was referred. According to the article 2a the new institutions (added to credit and financial institutions) who the Directive imposed its obligations were:

- auditors, external accountants and tax advisors;
- real estate agents;
- notaries and other independent legal professionals, in particular cases<sup>45</sup>
- dealers in high-value goods, such as precious stones or metals, or works of art, auctioneers, whenever payment is made in cash, and in an amount of €15.000 or more;
- casinos

As we say above, this Directive had given a wider definition of money laundering (not only money laundering of the proceeds of drugs offences), based on a increased range of underlying offences, as reflected to the revision of the FATF recommendations (happened in 1996). This extension facilitated suspicious transactions reporting and the international cooperation in this area.

*EU Directive 2005/60/CE of October 2005 (Third Directive)*

The issue of this Directive has abrogated both the first (91/308/CEE) and second (2001/97/EC) Directives. This third Directive has been draw up for two reasons: first, the Commission wanted to point out a clear reference of terrorist financing, asserting that “ the preventive measures of this Directive should cover not only the manipulation of the money derived from crime but also the collection of money or property for terrorist purposes”; second, since the FATF Recommendations were mostly revised and increased in 2003, the Commission has considered worthwhile that a new Directive should be in line with the new and revised international standards.

The first Directive (91/306/ECC), though imposing a customer identification obligation, contained relatively little detail on the relevant procedures. The newness thing of this Directive is the main focus, which the subjects of the obligations must have, in respect of the identification and verification of the “beneficiary owner”. For this purpose it is essential to clarify a precise definition of beneficial owner: according to art. 3 “beneficial owner” means the natural

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<sup>45</sup> See 2001/97/EC Directive, article 2a, n°5

person(s) who ultimately owns or controls the customer and/or the natural person on whose behalf a transaction or activity is being conducted”<sup>46</sup>.

The institutions covered by this Directive have to apply customer due diligence measures always using a risk-based approach. These customer due diligence measures consist in:

- Identifying the customer and verifying the customer’s identity on the basis of documents obtained from a reliable source;
- Identifying the beneficial owner and taking risk-based and adequate measures to verify his identity;
- Obtaining information on the purpose and intended nature of the business relationship;
- Conducting ongoing monitoring of the business relationship including scrutiny of the transactions undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with the institution’s or person’s knowledge of the customer, the business and the risk profile, including where necessary the source of funds and ensuring that the documents, data or information held to kept up-to-date.<sup>47</sup>

The customer due diligence and the identification of beneficial owner is an important point of this Directive. This procedure has to be conform to the risk of money laundering linked to the customer profile involved. In other words the extent of the measures has to be appropriate in the view of the risk of money laundering and terrorist financing. For this reason the Directive describes two type of due diligence: a “simplified customer due diligence” and “enhanced customer due diligence”. We adopt “simplified customer due diligence” in the cases when “the customer is a credit of financial institution covered by the Directive or a credit or financial institution situated in a third country which imposes requirements equivalent to those laid down in the Directive and supervised for compliance with those requirements”. In addition to this, the simplified customer due diligence could be apply when the customer is a listed company whose securities are trading on a regulated market in one or more Member States; or when the customer is a listed company from third country which is subject to disclosure requirements consistent with Community legislation. Instead, we adopt “enhanced customer due diligence” when naturally the risk of money laundering and terrorist financing is high. The most recurring cases, of applying these enhanced measures, are when the customer, for example, is not physically present so it is difficult to identify it if we don’t do enhanced controls; another case

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<sup>46</sup> See Directive 2005/60/CE October 2005 art 3

<sup>47</sup> See Directive 2005/60/CE October 2005 art 9

could be when there is a cross-frontier correspondent banking relationship with respondent institutions from third countries.

Another important point of this Directive is about the reporting obligations. It consist in the fact that the subjects covered by the Directive have to pay attention to any activity which they consider to be related to money laundering or terrorist financing and promptly informing of that the FIU. The FIU is the Financial Intelligent Unit that has to be established in each Member State in order to fight adequately money laundering. It is a central national unit that is responsible for receiving, analyzing and disseminating disclosures of information which concern potential money laundering. In addition to the reporting obligation the Member States require to the subjects covered by the Directive to refrain from carrying out transaction which they know could be suspect or related to money laundering, until they inform first the FIU, but where the refrain is not possible because is likely to frustrate the efforts to pursue beneficiaries, the institutions and persons concerned shall inform the FIU immediately afterwards.

### ***3.2 Italian Regulation***

The Italian Anti-Money Laundering regulatory system consists of an institutional framework that is continually updating with the international one, the European Directives and the FATF Recommendations.

Currently Italy has to deal with high amount of illegal proceeds, which more are domestically generated. The FATF reports some estimates that are included in a range from 1.7%-12% of GDP. This range, translated in money, is equivalent to €27.5-194.4 billion<sup>48</sup>. We have to specify that the estimates in the lower end of the range are based on household surveys and on indicators related to crime, instead estimates at the upper end of the range are based on comparisons of macroeconomic indicators.

In Italy the main crimes that generate illegal proceeds can be grouped in three categories<sup>49</sup>:

- Tax and excise evasion (around 75% of the total proceeds of crime)
- Drug trafficking and loan sharking (around 15% of total proceeds)

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<sup>48</sup>FATF, Anti-money laundering and counter-terrorist financing measures, Italy, 2015

<sup>49</sup> See Italy's National Risk Assessment, 2014, p-9-26

- Corruption, bribery, fraud, smuggling, extortion, illegal gambling (around 10% of total proceeds)

According to the National Risk Assessment's authorities, most of these crimes are closely connected and controlled to organized criminality, which has been always like an open wound for Italy. In fact, our Country has historically suffered from a high rate of organized criminal activity linked to organized crime structures, such firstly Mafia, Camorra, N'drangheta, etc. Historically, these criminal structures were predominant in the South, now they have spread throughout the Country and cross the borders. They have become sneakier, and so less visible in respect to the past, because they have become entrepreneurial criminal organization that have penetrated into the legitimate economy<sup>50</sup>.

Currently according to the FATF report the channel most vulnerable to money laundering seems to be the banks and BancoPosta. The report states that: "this is due to their preponderance in the financial sector, to the range of products they offer, the transaction volumes they handle, and the interconnectedness of the banking sector with the international financial system. This vulnerability is to a fair degree offset to implementation of antimoney laundering measures by banks and competent authorities".

Italy has a strong regulation for fight money laundering and terrorism financing: the measures are quite strict about the assessment of the risk, law enforcement, confiscation, transparency of legal persons and arrangements; but they are not so strong about the sanctions linked to money laundering and about the preventive measures for designated non-financial business and professions.

### ***3.2.1 from the law n. 191 of 1978 to the Legislative Decree n. 231 of 2007***

The crime of money laundering in Italian jurisdiction was introduced for the first time with the Law n.191 of 18<sup>th</sup> May of 1978, which carries the articles 648bis (that identifies as predicate offences of money laundering only the categories of armed robbery, extortion or abduction finalized to the extortion).

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<sup>50</sup> Soriani C., Riccardi M., From illegal markets to legitimate businesses: the portfolio of organised crime in Europe, 2015

This article had got modified after some years by the law of 19<sup>th</sup> March of 1990, which had amplified the categories of predicate offences of money laundering and introduced the article 648ter (that punish the use of money or assets of illicit origins).

The transposition of the First Directive (1991/308/CE) in the Italian jurisdiction was accomplished with the law n.197 of 5<sup>th</sup> July of 1991. This law has introduced the reporting obligation.

The transposition of the Second Directive (2001/97/CE), was accomplished in Italy with the law n.56 of 2004; it extended the money laundering measures to the category of the “professionals”

The transposition of the Third Directive (2005/60/CE), was accomplished with the Legislative Decree n. 231 of 2007 that has introduced a new approach to prevention and fight of laundering based also on, the active cooperation of the credit and financial institutions, insurances and professionals categories.

### ***3.2.2 Legislative Decree n. 231 of 21th November of 2007***

It is the main legislative framework (with subsequent amendments and integrations) for prevention money laundering and terrorism financing. It represents the transposition of the Third European Directive of 2005 into an Italian Decree. It established the obligations that the subjects must obey in order to help the authorities prevent and fight laundering of illicit money and international terrorist financing.

The main requirements of this Legislative Decree concerns:

- Identify and monitor of the clients and/or the transaction partner, called customer due diligence obligation, with explicit indication of when (for example establishment of a business relationship) and how (for example procedure to identify the real beneficial owner) to accomplish these obligation.
- Adopting the risk-based approach: so according to the level of customer’s risk profile , the institutions choose which customer due diligence apply (simplified or enhanced). For example for credit and financial institutions and the other categories submitted to this Decree, it will be applied a simplified customer due diligence; for not physically present clients , for politically exposed persons, and for customer with high risk profile will be applied an enhanced customer due diligence)

- Obligation to refrain from establish a business relationship or maintain ones if is not possible to identify the customer fulfilling the customer due diligence obligations, or if there a suspicion of money laundering, and so the obligation to report these suspicious activities.
- Commitment to record the transactions and operations executed in the Single Electronic Archive, called “Archivio Unico Informatico” (“Instructions” of 2013 issued by the Bank of Italy, require that credit and financial institutions register operations and relationship that they have with their customers through the AUI so to allow the reconstruction of the path of each client using a common standard)<sup>51</sup>.
- commitment to monitor all the transactions with countries that threat international security (countries included in Sanction List)
- Commitment to adopt adequate staff training measures to guarantee the application of legislative provisions.

A very important news that the Legislative Decree carries out is the new powers assigned to the Bank of Italy. In fact with this Decree, the Bank of Italy has a role of supervisory authority, in partnership with the Ministry of Economic and Finance; it has acquired regulatory and control power, and the power to impose penalties on supervised individuals.

The bank of Italy has got the power to issue: the provisions containing anomaly indicators for intermediaries to facilitate identification of suspicious activities; the implementing Rules for organization, internal control and procedures that concern anti-money laundering measures and the implementing Rules for customer due diligence and for keeping the Archivio Unico Informatico<sup>52</sup>.

### ***3.3 Toward the Fourth Directive***

The new Directive 2015/849 EC on the prevention of the use of the financial system for the purposes of money laundering and terrorist financing has been approved after a long legislative procedure and it is going to become the Fourth European Directive.

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<sup>51</sup> Grillo A., The anti-money laundering report, 2014, p.6

<sup>52</sup> Guidelines for the fight against money laundering and terrorist financing and for handling of embargoes, Intesa San Paolo, January 2014, p.4

It has recognized the FATF Recommendations updating in 2012. Its issuing process was characterized by a strong debate with group of representatives of each Member State to highlight critical issues that could be object of modification during the issuing process: the European Commission has drawn up estimation of negative economic impact derived from money laundering. Between the causes of this impact we can find firstly the different implementation of the Directives in each Member State; then the incompleteness of the current European regulations; and insufficient congruence between the current regulation and the international standards. To solve this problems, one of the purposes of the legislator of the Directive has been to guarantee more uniformity between the national regulations.

This directive will abrogate the 2005/60/CE Directive and the 2006/70/CE started to 26<sup>th</sup> June 2017, date in which it will become active. It follows that this date will be the deadline for the transposition of the Fourth Directive into a national law that it will be going to modify the Legislative Decree 231/2007 currently in effect.

This Directive brings some novelty in compares to the precedent ones.

The Directive firstly applies to the financial sector including banks, company service providers , lawyers , accountants, trusts, and all intermediaries in goods making or receiving cash payments in excess of €10.000 ( this amount is a limitation of the previous amount of €15.000 under the Third Directive), regardless of the payment is made in one or more transactions. Another novelty is the introduction in the offences (art.3 co.4 f ) of “the tax crimes relating to direct taxes and indirect taxes and as defined in the national law of Member States, which are punishable by deprivation of liberty or detention order for a maximum of more than one year or, as regards Member States that have a minimum threshold for offences in their legal system, all the offences punishable by deprivation of liberty or a detention order for a minimum of more than six months”.

The Directive reaffirms the importance of the use of the risk-based approach in a “holistic” way, so it has been recognized the importance of a supranational approach to risk identification at international level. For this purpose some European Supervisor Authorities have been tasked to issue opinion on the risk affecting the Union financial sector; these organisms are the European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), European Securities and Markets Authority (ESMA). By 26 June 2017 the ESAs shall issue guidelines addressed to competent authorities in accordance with current EU Regulations

on characteristics of risk-based approach supervision and the steps to be taken when conducting supervision on risk-based basis.

Another novelty are the measures to ensure more transparency and accessibility to the information on the beneficial owner: for that purpose in each Member State that kind of information will be held in a central register, like for example a commercial register, companies register, or public register.<sup>53</sup>The features of the register has to be notify by each Member State to the Commission. By June 2019 The Commission shall draw up a report to the European Parliament and Council where it assert the conditions and the technical specifications for ensuring the interconnection of the central registers of the Member States via the European central platform.

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<sup>53</sup> Art.30 3), IV Directive



## *Chapter 4*

### *The comparative analysis between legal companies and criminal connected companies*

The last part of the thesis of money laundering is based on a statistical analysis of data collected by analyzing Balance Sheets and Income Statements of each company (criminal and legal) taken into consideration.

The aim of this research, based on the financial statements of the legal and criminal firms, is to understand which could some metric and indicators, computed using annual reports values which help us to understand and to identify some reasonable warning about the possibility that a company is used for criminal purpose like money laundering.

The analyses were performed comparing financial index and balance sheet items of criminal companies with a sample of non-criminal companies.

#### *4.1 Overview of the samples*

In our analysis we take into consideration two samples: CRIMINAL and LEGAL.

The sample CRIMINAL is the result of previous research activities carried out at the Department of Economics and Management of the University of Padova, which, after an analysis of 120 anti-mafia operations conducted by law enforcement agencies, have identified a list of people embroiled in money laundering. The database Telemaco (that is a service offered by the Chamber of Commerce which allows the access to corporate information of the “Registro delle imprese italiano” and European Business Register), allowed to check whether these people were members or shareholders of Italian companies. The starting assumption is that these people use companies to launder money or to conceal illegal activities. Once obtained the list of criminal companies, it has observed only the years when the suspected people had the role of executive or shareholder in the companies. For each of these years, it has been searched the correspondent Financial Statements by using TELEMACO or the database AIDA. At the end we collected 206 financial statement that have become the sample CRIMINAL of our analysis.

For the sample LEGAL, we refer to a particular type of companies that had acquired the legality rating. After that the two samples have been analyzed by using the software STATA.

Now we want briefly describe what the legality rating is in order to understand clearly what type of legal firms we have considered.

#### ***4.1.1 The Legality Rating***

On 15 November 2012, the Parliament approved the Implementation Regulations for the so-called Legality Rating, a new tool designed to increase the competitiveness of Italian companies by promoting ethically sustainable development. The Rating is a certification (expressed as a numerical score, from a minimum of 1 to a maximum of 3) issued by the Autorità Garante della Concorrenza e del Mercato (AGCM) to financial and non-financial companies that have submitted the relative application, declaring themselves to be in full compliance with the specific industry regulations.

In order to obtain the Rating the applicant company must first of all demonstrate that:

- In the last two years, it has not been convicted by a final judgment of antitrust crimes and crimes regarding taxation, labour law or referring to the withdrawal of public funding;
- It has implemented the traceability of payments for amounts over 1,000 euro;
- It has not been convicted of tax offences and crimes against the public administration, and no criminal proceedings have been brought against individual entrepreneur (individual business), partners and top executives (large companies).

Each company may also increase its base rating if it demonstrates that:

- It has adopted processes aimed at encouraging Corporate Social Responsibility within the company;
- It complies with the contents of the “Legality Protocol” endorsed by the Italian Ministry of the Interior and by Confindustria;
- It uses the traceability systems even for amounts of less than 1,000 euro;
- It has adopted an organizational model pursuant to Italian Legislative Decree no. 231 of 8 June 2001.

The Legality Rating first of all highlights the key role of the internal antitrust compliance initiatives and also recommends the adoption by companies of far-reaching programs that promote training even outside of the corporate scope to include trading partners and customers<sup>54</sup>.

Most of the requests come from the North of Italy (43.3%), in respect to 22% in the Centre and 31.7% in the South (South and the islands). Over 62% are concentrated in five regions, with Sicilia at the top (14%), followed by Lombardia (13.2%), Veneto (13%), Lazio (12.3%) and Emilia Romagna (10.3%).

Around 80% of the companies that have requested the rating of legality have a turnover between EUR 2 and 50 million per year. Less than 3% have a turnover of over EUR300 million. Most have less than 100 employees (78%), against a 3% that employ more than 1 000 persons.

Depending on the type of activity, about 25% of the applicant companies operate in areas known as “sensitive”, such as construction, transportation of goods and people, and the disposal of waste. The largest share consists of limited liability companies (55.19%), followed by shared companies (31.39%)<sup>55</sup>.

So the sample LEGAL that we made, collecting financial statement using TELEMACO and AIDA, it is a very particular sample that represents high performing companies.

#### ***4.2 Analysis of the data***

Money laundering activities may range from a single act (e.g. being in possession of the proceeds of one’s own crime) to complex and sophisticated scheme involving multiple parties and multiple methods of handling and transferring criminal properties. The First Chapter presented many type of money laundering techniques; the Second Chapter, instead, presented money laundering methods that involved the misuse of companies. Businesses and individuals need to be alert to the risks of money laundering in any of its possible form. For this reason this Chapter presents an analysis that allows us to know if there are differences (on accounting level) between Criminal companies and Legal Companies. It can be assumed that some

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<sup>54</sup> [http://www.group.intesasanpaolo.com/script/sir0/si09/contentData/view/Rating\\_Legalità/pdf](http://www.group.intesasanpaolo.com/script/sir0/si09/contentData/view/Rating_Legalità/pdf)

<sup>55</sup> <http://www.agcm.it/en/newsroom/press-releases/2196-boom-of-requests-to-antitrust-authority-to-obtain-the-rating-of-legality.html>

financial statements items, index could differ from one sample to the other one. This assumption is based on the fact that criminals are not mainly interested in increasing the synergies and make profits because they use the company as a tool to launder money and to derive benefits from their illegal activities. For example often criminals achieve their objectives through the use of shell companies which is an incorporated company that possesses no significant assets and does not perform significant operation. To launder money, the shell company purports to perform some service that would reasonably require its customers to pay often in cash. Cash transaction increases anonymity and decreases government's ability to trace the initial recipient of dirty money. The launderer deposits the dirty money on the shell company which deposits it into accounts. The company then creates fake invoices and receipts to account for the cash. Such transaction create the appearance of property and clean money. In this way shell company can make withdraws and return the money to the initial criminal.

Before starting the analysis, we created our dataset by taking in consideration financial statements from years 2004 to 2015. The dataset is composed by 1855 unique firms; in particular it is composed by 651 Criminal firms and 1204 Legal firms.

After created the samples Legal and Criminal, we have proceeded to analyze many performance indicators which could be relevant for the purpose of identifying significant differences between companies that do effectively business in the market and companies that are in the market either, but they are used to reinvested illegal capitals in the legal economy.

The analysis focus firstly on Roe, then we have broken down it into three components, that are Roa, Leverage, and Incidence of non-operating income, so to understand better why the Roe has its current value; after that we focus on revenues, and costs indicators to have a general and complete picture of the two samples taken into consideration.

### 4.3Roe analysis

The Return on Equity (ROE) is a profitability ratio that measures the ability of a firm to generate profits from shareholders' investments in the company; with other words ROE shows how much profit each euro of common stockholders 'equity generates (for example a return of 1 means that every euro of common stockholders 'equity generates 1euro of net income). It is an important indicator for potential investors who want to see how efficiently a company will use their money to generate net income; it is also an indicator that tells us how effective management is at using equity financing to fund operations and grow the company.

It is calculated by dividing Net Income over Shareholder Equity; after that we proceeded to the winsorization of the Roe for both the two samples with Stata, generating a new variable called roe\_w. The winsorization is an operation that limits extreme values in the statistical data to reduce the effect of possibly spurious outliers; in our case we have winsorized all the data at 1%.

It is reported below all the data regarding roe indicator:

**TABLE 1. Descriptive Statistics of Roe**

VARIABLE	OBSERVATIONS	MEAN	STANDARD DEVIATION	PERCENTILE 25%	PERCENTILE 50%	PERCENTILE 75%
Roe	12605	0.078	0.433	0.004	0.059	0.186

**TABLE 2. Result from ttest**

VARIABLE	MEAN (LEGAL)	MEAN (CRIMINAL)	DIFFERENCE	P VALUE	STATISTICAL SIGNIFICANCE
Roe	0.083	0.058	0.025	0.009	***

**TABLE 3. Results from the regression**

VARIABLE	ROE
Criminal	-0,02 [0,019]
Size	0,002 [ 0,004]
Industry fixed effects	yes
Regions fixed effects	yes
Years fixed effects	yes
Observation	12600
R-squared	0,01

*Note: the numbers inside the squared brackets are referred to the standard error*



*Figure 1 Difference of the means*

From the table above we can notice that the two means are different. In the case of the sample Legal we've obtained a mean equal to 0.083; for the sample Criminal the mean is equal to 0.058. This implies that the mean of Roe for Legal firms is equal to 8.3%, instead the means of Roe for the Criminal firms is equal to 5.8%.

Even if Criminal Roe is lower in respect of the Legal Roe, it is a result of considerable interest, because the two means (Legal and Criminal) are still above the normal average value of Roe (usually a normal firms has 2% of Roe).

Next step of the analysis is to make a ttest; we use this test for comparing the means of two samples (or treatments), even if they have different numbers of replicates. In simple terms, the t-test compares the actual difference between two means in relation to the variation in the data (expressed as the standard deviation of the difference between the means).

First we need to construct the null Hypothesis ( $H_0$ ) that would be that there is no difference in the two means observed. The statistical relevance of the analysis of the means is based on testing  $H_0$ .

It is possible to notice that the probability that  $H_0$  (the difference between the means is equal to 0) could be verified, is equal to 0.9%; so we can say that the ttest has strong statistical significance and we reject  $H_0$ . The threshold level of statistical acceptance is 5% ; over this threshold we assert that the possibility that  $H_0$  could be true , it is not due (happening) by chance. It seems that the Criminal companies are been able to generate profits from its shareholder's investments as much as a normal companies and even more (we remember that a normal company that has a Roe equal to 2% on average)

The analysis, however, is not considered exhaustive because there are so many factors that could possibly influenced the samples and so the result of the analysis. For example one factor that could influence our results is the size of the company; another one is the business sector of the company: firms that are in different sector of the market, have to satisfy different needs and sustain different costs in order to face different scenarios; so it's hard to make a comparison of Roe between for example firm that operates in agricultural industry and a firms that operates in service industry.

To solve this problem, it is necessary to conduct a multiple linear regressions, which takes into

account the factors described above. First of all, it was necessary to tabulate the ATECO codes (to highlight the companies industries) and the years taken in consideration. In addition, it has been generated a new variable (to take in account the factor of the size of the company) calculated as the logarithm of the total assets of the companies. The new variable, called “size\_w”, has been winsorized at 1% like the variable Roe.

The linear regression predicts scores on one variable from scores on others variables. The variable we are predicting is called the dependent (or criterion) variable and is referred to as Y. The variables we are basing our predictions on is called independent (or predictor) variable and is referred to as X. If the goal is the prediction, or forecasting, or error reduction, linear regression can be used to fit a predictive model to an observed data set of Y and X values. In our case the Roe is identified as the dependent variable, the Criminal coefficient as independent variable, then we added the other factors (size, dummies Ateco, years and Regioni) that has to be taken in consideration for the reason explained above; so the industry sector, the years, and the size of the companies has been made uninfluential.

It has been chosen to assign a level of statistical significance as described below:

- If  $P \text{ value} \leq 0.01$  we assign [\*\*\*] (strong significance)
- If  $0.01 < P \text{ value} \leq 0.05$  we assign [\*\*] (significance)
- If  $0.05 < P \text{ value} \leq 0.1$  we assign [\*] (slight significance)

After calculated the regression, we saw that the P value resulted is not significant anymore (0.296). But our research doesn't stop here and we want to take a deeper analysis about the Roe by its decomposition in other indicators: Roa, Leverage and Incidence of non-operating income

#### ***4.4 Roa analysis***

Roa is the return on assets; it represents a profitability ratio. It indicates how profitable a company is relative to its total assets .It is calculated as Operating Income over Total Assets. We applied the same analysis that we have done for the Roe, with the following results:

**TABLE 4. Descriptive statistics of Roa**

VARIABLE	OBSERVATIONS	MEAN	STANDARD DEVIATION	PERCENTILE 25%	PERCENTILE 50%	PERCENTILE 75%
<b>Roa</b>	12601	0.044	0.094	0.011	0.038	0.076

**TABLE 5. Result from ttest**

VARIABLE	MEAN (LEGAL)	MEAN (CRIMINAL)	DIFFERENCE	P VALUE	STATISTICAL SIGNIFICANCE
<b>Roa</b>	0.054	0.004	0.05	0.000	***

**TABLE 6. Results from regression**

VARIABLE	ROA
Criminal	-0,044*** [0,005]
size	0,003*** [0,001]
Industry fixed effects	yes
Regions fixed effects	yes
Years fixed effects	yes
Observation	12601
R-squared	0,069

**2Note:** the numbers inside the squared brackets are referred to the standard error



*Figure 3 Difference of means*

Observing the two means we can notice that the value of Roa for the sample legal is definitely higher (5.4%) confronted to the one of the sample Criminal (0.4%); this is confirmed by the ttest and by the regression where we have obtained a P value equal to 0 .

#### ***4.5 Leverage analysis***

After the Roa, we have proceed to analyze the Leverage, the second element that could possibly influenced the Roe indicator.

From a company's point of view, the use of financial leverage can positively (or sometimes negatively) impact its return on equity as a consequence of the increased level of risk. Conceptually, a company's return on equity increases because the use of leverage increases the stock volatility, increasing its level of risk which in turn increases the returns. However if a company is financially over-leveraged a decrease in return could occur: if the risk of investment outweighs the expected return, the value of the company equity could decrease as the stockholders believe it to be too risky. Our analysis starts with the assumption that the Leverage for the criminal companies is higher than the leverage of the legal companies.

The Leverage is calculated as the ratio between Total Assets minus Shareholder's Equity, over Total Assets.

**TABLE 7. Descriptive Statistics of Leverage**

VARIABLE	OBSERVATIONS	MEAN	STANDARD DEVIATION	PERCENTILE 25%	PERCENTILE 50%	PERCENTILE 75%
Leverage	12601	0.754	0.241	0.629	0.796	0.911

**TABLE 8. Results from ttest**

VARIABLE	MEAN (LEGAL)	MEAN (CRIMINAL)	DIFFERENCE	P VALUE	STATISTICAL SIGNIFICANCE
Leverage	0.739	0.815	-0.076	0.000	***

**TABLE 9. Results from regression**

VARIABLE	LEVERAGE
Criminal	0,042*** [0,016]
Size	0,008*** [ 0,004]
Industry fixed effects	yes
Regions fixed effects	yes
Years fixed effects	yes
Observation	12600
R-squared	0,235

*4Note: the numbers inside the squared brackets are referred to the standard error*

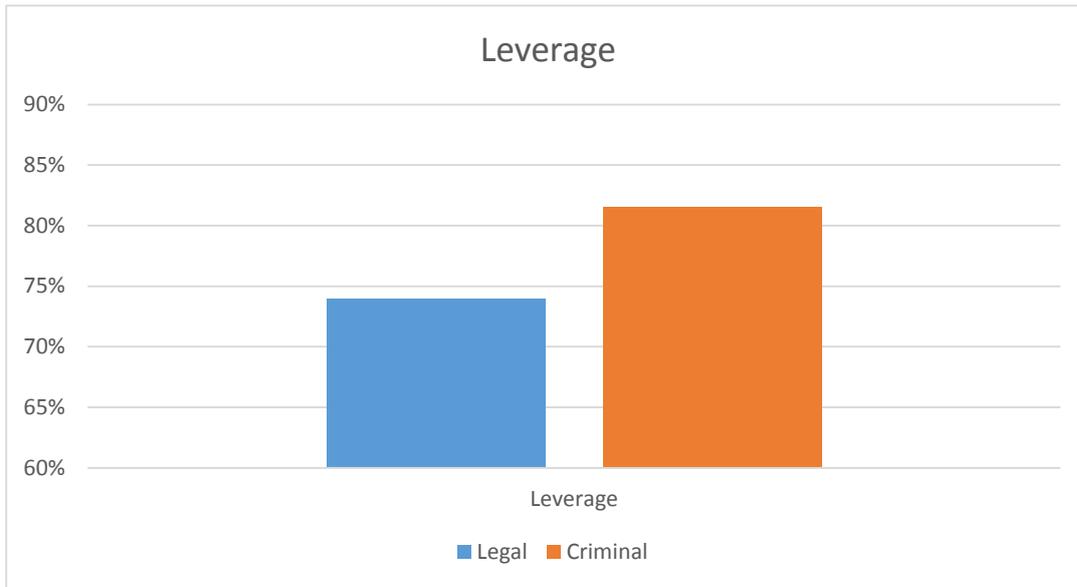


Figure 5 Differences of the means

We can notice that the mean for criminal companies is 81.5 % against 73.9 % of the mean of legal companies. This could signify that the capital given by third parties is higher in criminal firms rather than legal ones; this is confirmed even by the ttest and the regression.

From these results we can hypothesize that money launderers use companies in this way: they increase the liquidity inside the company by raising funds and loans from third parties, so with that they could use this amount of money to increase gains and to make legal their dirty money that had necessity to be cleaned.

#### ***4.6 Incidence of non-operating income***

It is the third indicator that can influence the Roe. It represents the bearing of non-working operations on the operating income. This ratio highlights the influence of fiscal, finance and extraordinary management on the fiscal year result. It has been calculated with the ratio Net Income over Operating Income

Here there are the results obtained:

**TABLE 10. Descriptive Statistics of Incidence of non-operating income**

VARIABLE	OBSERVATIONS	MEAN	STANDARD DEVIATION	PERCENTILE 25%	PERCENTILE 50%	PERCENTILE 75%
Incidence of non-operating income	12479	0.434	1.464	0.084	0.398	0.659

**TABLE 11. Results from ttest**

VARIABLE	MEAN (LEGAL)	MEAN (CRIMINAL)	DIFFERENCE	P VALUE	STATISTICAL SIGNIFICANCE
Incidence of non-operating income	0.385	0.636	-0.251	0.000	***

**TABLE 12. Results from regression**

VARIABLE	INCIDENCE OF NON-OPERATING INCOME
Criminal	0,223*** [0,055]
Size	-0,006*** [ 0,012]
Industry fixed effects	yes
Regions fixed effects	yes
Years fixed effects	yes
Observation	12475
R-squared	0,011

*6Note. The numbers inside the squared brackets are referred to the standard error*

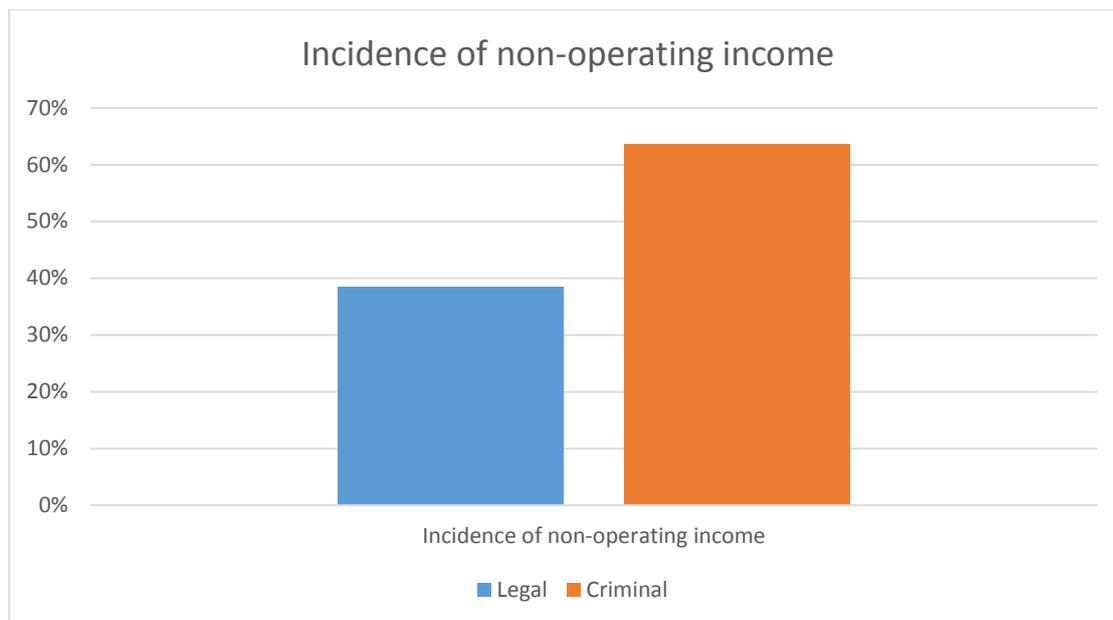


Figure 7 Difference of the means

As we can see from the data above the average value of all dataset is 43%. In particular, for criminal firms the mean is 63.6%, almost the double in comparison on the legal firms that have a mean of 38.5% of this indicator.

These are significant results as the ttest highlights a p value of 0.001 and this is confirmed even by the regression where the p value remains the same.

We are not surprise by the these results, because it was expected: as criminal firms are not used to create value and make business but they are only misused as a tool for laundering money, this implicates that the value of non-working operations is higher in respect to the value of core business operations.

From the decomposition of Roe in Roa, Leverage and Incidence of non-operating income, we see that the last two are very significant and in particular the Incidence of non-operating income contributes negatively to the formation of Roe indicator.

#### ***4.7 Ros and Turnover analysis***

In this paragraph we proceed to the breakdown of the Roa index in two indicator: Ros (Return

on sales) and Turnover (number of times an inventory or invested capital was turned into cash during an accounting period).

The initial assumption is that the Ros in the Criminals is lower on average in respect of the legal ones because we expect pumped costs which influence negatively the operating income and so the Ros. The Ros index is been calculated as Operating Income over Sales Revenues.

**TABLE 13. Descriptive Statistics of Ros**

VARIABLE	OBSERVATIONS	MEAN	STANDARD DEVIATION	PERCENTILE 25%	PERCENTILE 50%	PERCENTILE 75%
Ros	11874	0.041	0.165	0.016	0.039	0.077

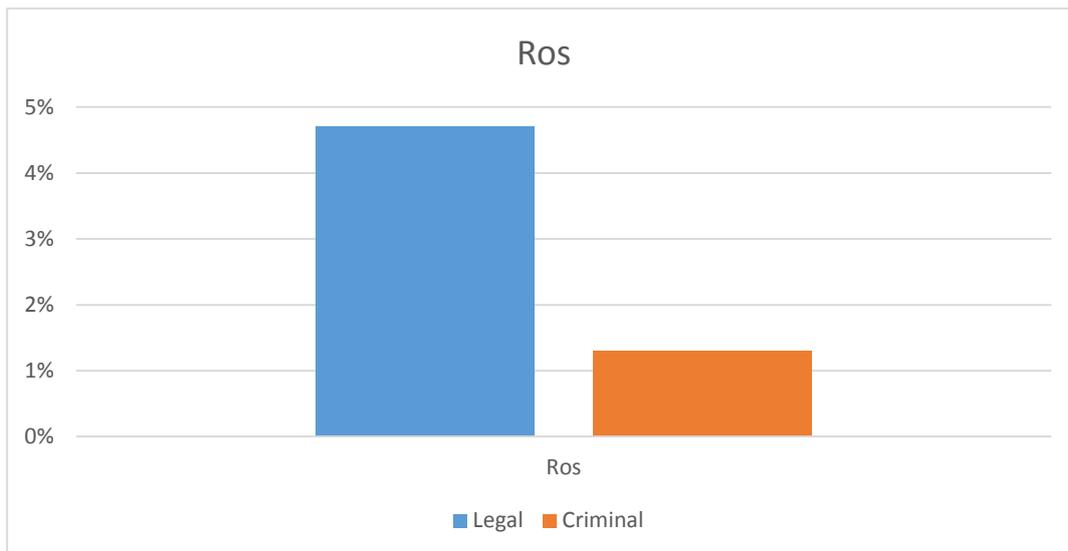
**TABLE 14. Results from ttest**

VARIABLE	MEAN (LEGAL)	MEAN (CRIMINAL)	DIFFERENCE	P VALUE	STATISTICAL SIGNIFICANCE
Ros	0.047	0.013	0.034	0.000	***

**TABLE 15. Results from regression**

VARIABLE	ROS
Criminal	0,043*** [0,011]
Size	-0,007*** [ 0,002]
Industry fixed effects	yes
Regions fixed effects	yes
Years fixed effects	yes
Observation	11872
R-squared	0,036

*Note.* The numbers inside the squared brackets are referred to the standard error



*Figure 8 Difference of the means*

As we expected, the results confirm the initial assumption: for the Criminal firms Ros is 1.3% while for the Legal is much higher about 4.7%. The P value is equal to 0,000 and the regression confirmed this value, so there is a strong statistical significance.

We can say that the Ros of the Criminals is due to the costs and revenues maybe because they are “pumped” in order to launder dirty money.

Because the Ros is lower in Criminal firms, this could imply that the operating income (which is the numerator of the ratio) is on average lower in Criminal firms in respect to the Legal ones; instead the revenues (which are the denominator of the ratio) are higher on average in the Criminal firms, so this could mean that criminals “pump” their revenues as a method to launder dirty money.

The Turnover is the second factor that influences Roa. Its ratio is Sales Revenues over Total Assets.

The results are showed below:

**TABLE 16. Descriptive Statistics of Turnover**

VARIABLE	OBSERVATIONS	MEAN	STANDARD DEVIATION	PERCENTILE 25%	PERCENTILE 50%	PERCENTILE 75%
Turnover	12601	1.105	0.765	0.616	1.032	1.481

**TABLE 17. Results from ttest**

VARIABLE	MEAN (LEGAL)	MEAN (CRIMINAL)	DIFFERENCE	P VALUE	STATISTICAL SIGNIFICANCE
Turnover	1.19	0.769	0.421	0.000	***

**TABLE 18. Results from regression**

VARIABLE	TURNOVER
Criminal	0,466*** [0,048]
Size	-0,095*** [ 0,011]
Industry fixed effects	yes
Regions fixed effects	yes
Years fixed effects	yes
Observation	12601
R-squared	0,189

*Note.* The numbers inside the squared brackets are referred to the standard error

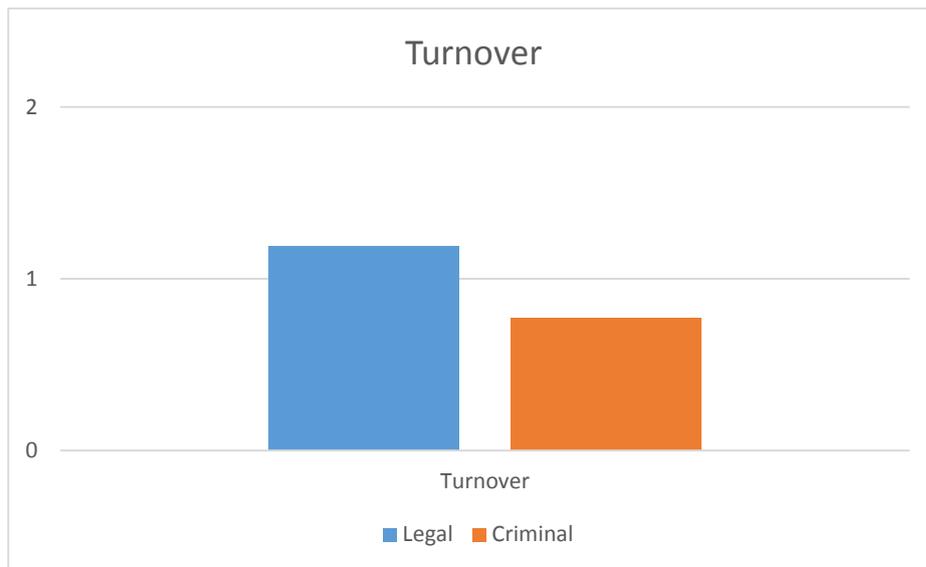


Figure 9 Difference of the means

The mean of Turnover for the Legals is 1.19, instead for the Criminals the means is equal to 0.77. So we notice a lower value in the Criminal companies that explains the lower value of the Roa for the firms that are used to launder money.

The observations are confirmed by the ttest and the regression, where the P value is  $< 0.01$ .

In this case we can assume that the results obtained derive from costs of the core business: because of the consistent investments due to the liquidity available, we have lower revenues in average in respect to the bearing of the costs.

#### 4.8 Leasing

The last indicator we want to analyze is the expenses for leased assets to third parties. It has been calculated with the ratio leasing over Sales Revenues.

The starting assumption is that criminal firms try to “pump” some costs (i.e. rents for real estates, additional fees, royalty fees for the use of software, patents, know-how, etc...) by faking invoices or by using the instrument of leasing in illegal way to launder dirty money. The second method seems to be hard to apply today because of the awareness increased thanks to the FIU’s (Financial Intelligent Unit) framework of anomaly behavior about operation connected with illegal leasing activities.<sup>56</sup>

So we will expect a higher mean in criminal firms respect to the legal firms.

<sup>56</sup> UIF, Unità di informazione finanziaria per l’Italia, *comunicazione UIF 17 gennaio 2011*, available on <https://uif.bancaditalia.it/normativa/norm-indicatori-anomalia/COMUNICAZIONE-180111.pdf>, 2011

Here there are the results:

**TABLE 19. Descriptive Statistic of Leasing**

VARIABLE	OBSERVATIONS	MEAN	STANDARD DEVIATION	PERCENTILE 25%	PERCENTILE 50%	PERCENTILE 75%
Leasing	11874	0.044	0.074	0.008	0.024	0.051

**TABLE 20. Results from ttest**

VARIABLE	MEAN (LEGAL)	MEAN (CRIMINAL)	DIFFERENCE	P VALUE	STATISTICAL SIGNIFICANCE
Leasing	0.037	0.083	-0.046	0.000	***

**TABLE 21: Result from regression**

VARIABLE	LEASING
Criminal	0,027*** [0,005]
Size	-0,006*** [ 0,014]
Industry fixed effects	yes
Regions fixed effects	yes
Years fixed effects	yes
Observation	11872
R-squared	0,113

*Note.* The numbers inside the squared brackets are referred to the standard error



Figure 10 Difference of the means

As we expected, from the ttest we obtain this results: the value for criminal firms is much higher (8.3%) in respect to the value of the legal firms (3.7%), but since the firms taken into consideration operate in different industry, the most reliable observations are those of the regression, because it makes the industry factor not important.

We see from the regression that the P value doesn't change and remain  $< 0.01$ . So we can say that the criminal firms on average have always higher expenses for leased assets to third parties.

At the end of analysis, it seems interesting the fact that the main differences between the two samples have reference to external source of funding or supporting the business activity. Money could permeates inside companies by loans, dispensed from third parties, so to spread and dissipate the origin of the illegal money, and thanks to that, these firms appear as companies with higher profitability (see the Roe) respect to a normal firm.

## *Conclusion*

The principal goal of this thesis is to analyze the distinctive characteristics of criminal connected companies in order to find if could be a relationship between money laundering phenomenon and its repercussion in companies 'financial statements.

Based on the assumption that criminal firms are not business interested to create profits and synergies but they are only misused to launder money and hide the source of illegal proceeds, there are some features that distinguish that type of firms from other legal businesses.

This thesis presents many aspects of money laundering phenomenon.

In the First chapter it is described what is money laundering and its three stage process: the first stage involves the placement of illegal proceeds from the scene of crimes to a place (or a form) less suspicious and more convenient for the criminal; the second stage of laundering process is layering and involves the separation of proceeds from the illegal source through the use of complex transactions designed to obscure the audit trail and hide proceeds; the third stage is integration and represents the conversion of illegal proceeds into apparently legitimate business earnings through normal financial operations.

The Second Chapter describes many money laundering techniques using criminal connected companies; they are many and always changing in order to avoid the regulatory control.

The Third Chapter shows the international response to money laundering phenomenon; it has taken a number of forms including multilateral treaties, international organizations, and the identification of universal counter-laundering measures.

The last Chapter presents a statistical analysis of the main financial statements indicators in order to confirm our basis assumption and to find the characteristics (on accounting level) that distinguish the criminal connected companies from the legal companies. The analysis is composed by a descriptive statistics of the indicators, then it was made a ttest and a linear regression in order to make uninfluential factors relating to the firms (years, industry, size, Regions).

After we have analyzed the Roe indicator, we have instantly realized that the firms taken into consideration are high performance companies (both legal and criminal), even if the criminals Roe is lower than the one of the legal firms. This because the value on average of Roe is very high in respect of normal businesses (that is around 2%, instead of the two samples value

average that is around 7%).

Calling back the money laundering methods described in the first and second chapter, and in particular the “back to back loan” method, we have found significant result with reference to the connection between criminal operations and financial indicator.

Suppose that the main factor (of this method) is the obtaining of borrowings and loans from third parties that are external to the firm but however they're involved in criminal operations, we have proceeded to decomposing the Roe indicator in Leverage, Roa, and Incidence of non-operating income.

The results from Leverage indicator seems to be very interesting. We have calculated the Leverage as the ratio  $(\text{Total Assets} - \text{Shareholder's Equity}) / \text{Total Assets}$ ; in this way the results represents the capital funded by third parties.

We've noticed that the Criminal value (81.5 %) is higher in confront to the Legal value (73.9 %) with a significant P value that is  $<0.001$ .

This confirm our basis hypothesis: criminals increase the liquidity inside the company by raising funds and loans from third parties, so with that they could use this amount of money to increase gains and to make legal their dirty money that had necessity to be cleaned.

Another important results is from the Incidence of non-operating income: in this case we expected an higher value for the Criminal firms in respect to the Legal firms. In fact the results obtained confirm our expectation: we obtained a value of 38% for the Legal and 68% for the Criminal. So we can say without doubt that criminal firms are not used to create value and make business but they are only misused as a tool for laundering money, that is why value of non-working operations is very high, almost double the value of the Legal firms.

Another important result that we have found is about the costs in particular in relation to Leasing.

The empirical analysis has highlighted great bearing of the expenses for leased assets to third parties. We suppose that criminal use to “pump” these costs and revenues in order to hide an launder their illegal proceeds and so hide their illegal source.

Money laundering has become a global problem as a result of the confluence of several remarkable changes in world markets (i.e., the globalization of markets). The growth in international trade, the expansion of the global financial system, the lowering of barriers to international travel, and the surge in the internalization of organized crime have combined to

provide the source, opportunity, and means for converting illegal proceeds into what appears to be legitimate funds. Criminals engage in money laundering for mainly two reasons: first money represents the essence of the organization that engages in criminal conduct for financial gain because it covers operating expenses, restocks inventories, purchases service to corrupt officials, etc...; second, a trail of dirty money can become an incriminating evidence, to avoid that criminals must obscure the source of wealth or alternative disguise ownership or control to ensure that illicit proceeds are not used to prosecute them; the proceed from a crime often become the target of investigation and seizure, to avoid that criminals must conceal their existence or instead , make them to look legitimate.

As crime and money laundering methods evolve, the anti-money laundering regulations has to evolve as well. The international community's response to the challenge posed by money laundering has to address the financial, legal, and enforcement issues in a universal manner, through harmonization of remedies and cooperation between international institutions.



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