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Money Laundering for 21st Century Authoritarianism: Western Enablement of Kleptocracy

Ben Judah and Belinda Li
Kleptocracy Initiative

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Preface

When the Kleptocracy Initiative was founded in January 2014, shortly before the Russian invasion of Crimea, our project's original ambition was to expose how much leverage the United States and the European Union had over hostile kleptocracies like Russia and China, hidden in the murky world of offshore finance within Western jurisdictions.

Since then, banking sanctions and asset freezes targeting the elites of Russia, Syria, Iran, Venezuela, and North Korea have been adopted to further American foreign policy goals, playing a significant role in warding off further Russian action in Ukraine and securing nuclear concessions from Iran.

The research of the Kleptocracy Initiative then expanded to illustrate why the Western financial system has made contemporary globalization a friendly environment for kleptocrats like Russian President Vladimir Putin. Our October 2016 report, *The Kleptocracy Curse*, showed how the West provided safe spaces for corrupt elites to drain illicit wealth from their nations on a gigantic scale. Enabling kleptocracy, the report argued, has cursed U.S. foreign policy with strengthened authoritarianism, state failure, civil unrest and social degradation across the world.

We subsequently published two reports, *Weaponizing Kleptocracy: Putin's Hybrid Warfare,* and *How Non-State Actors Export Kleptocratic Norms to the West,* that highlight the different ways kleptocracies can infiltrate Western institutions and undermine U.S. national security. These works, in conjunction with our previous publications, *Stage Hands: How Western Enablers Facilitate Kleptocracy*, and *Cleaning Up Atlantis: How to Put a Kleptocracy on the Road to Transparency*, paint an alarming picture of Western financial entanglement with authoritarian states and build a framework for combatting kleptocracy and safeguarding Western democracies.

What was once a radical linkage between Western enablement and kleptocracy is now an emerging consensus. The new session of Congress starting in January 2017 has seen strengthening bipartisan support for making the Western financial system less friendly to kleptocrats. At least four bills have now been introduced to this effect - with their targets either Russian corruption or ending the formation of anonymous companies in the United States.

With this report, our lens switches from foreign to domestic policy. This report argues that the U.S. anti-money laundering (AML) system is inadequate to its purpose: first, because the existing system does not apply to key gatekeeper professions such as law, company incorporation, and real estate; and second, because its narrow application to the banking sector is outdated in an era of globalized financial services.

The failure to build an effective twenty-first century anti-money laundering system has led to systemic collusion with kleptocrats. Drawing on six months of research, over one hundred interviews and extensive discussions with U.S. law enforcement, this report highlights the limits of “self-regulation” and the need for policymakers to end the enabling of kleptocrats.

This report is not only an investigation into the workings of a shadowy financial system that is outstripping U.S. law enforcement, but also a call to action. Existing legislation must be expanded so that the legal, incorporation, and real estate sectors are clearly understood to be key AML responsibilities. Loopholes embedded in the existing system must be closed. And the existing AML structure must be both strengthened and updated to safeguard the Western financial system from 21st century kleptocrats.

--Ben Judah, Belinda Li, and Charles Davidson

Kleptocracy in America

Meet the Enablers

In 2016, the Kleptocracy Asset Recovery Initiative at the Department of Justice sought to seize more than $2.5 billion from foreign kleptocrats, mainly held in U.S. real estate and bank accounts.[1] Assets owned by kleptocrats in the United States represent only the tip of an iceberg of invisible criminal money laundering. The Department of the Treasury estimates that $300 billion is laundered annually in the United States.[2] This is roughly equivalent to the economic contribution of the U.S. mining sector or 2 percent of American GDP.[3] These shocking statistics expose by themselves the failure of the existing U.S. AML system.

This is underscored by the fact that America is also the international kleptocrats' favorite place to launder money. In a 2011 forensic study of grand corruption cases, the World Bank found that the United States was the leading jurisdiction of incorporation for the entities involved in the money laundering schemes.[4] "The money is coming from everywhere," says John Tobon, head of the Department of Homeland Security Investigations in Miami, where its Foreign Corruption Investigations Group is headquartered.[5] This should not be the case if the U.S. AML system were fit for its purpose.

Because many criminals lack the tools and expertise to launder their own money, they often hire "enablers" to help conceal their illicit activity. These enablers are individuals or businesses who engage in moving dirty money, or simply "the professional service providers that use their jobs to exploit the vulnerabilities in our system," explains James Barnacle, Chief of the FBI's Money Laundering Unit.[6] They use a variety of methods to

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[1] "VimpelCom Limited and Unitel LLC Enter into Global Foreign Bribery Resolution of More Than $795 Million; United States Seeks $850 Million Forfeiture in Corrupt Proceeds of Bribery Scheme," *U.S. Department of Justice*, February 18, 2016, https://www.justice.gov/opa/pr/vimpelcom-limited-and-unitel-llc-enter-global-foreign-bribery-resolution-more-795-million.
"United States Seeks to Recover More Than $1 Billion Obtained From Corruption Involving Malaysian Sovereign Wealth Fund," *U.S. Department of Justice*, July 20, 2016, https://www.justice.gov/opa/pr/united-states-seeks-recover-more-1-billion-obtained-corruption-involving-malaysian-sovereign.

[2] "National Money Laundering Risk Assessment," *U.S. Department of the Treasury*, June 12, 2015, https://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/National%20Money%20Laundering%20Risk%20Assessment%20%E2%80%93%2006-12-2015.pdf.

[3] "The Economic Contributions of U.S. Mining," *National Mining Association*, September 2016, http://nma.org/wp-content/uploads/2016/09/Economic-Contributions-of-Mining-in-2015-Update-final.pdf.

[4] "The Puppet Masters: How the Corrupt Use Legal Structures to Hide Stolen Assets and What to Do About It," *World Bank*, 2011, https://star.worldbank.org/star/sites/star/files/puppetmastersv1.pdf.

[5] John Tobon in discussion with the authors, June 20, 2017.

[6] James Barnacle in discussion with the authors, May 12, 2017.

help facilitate illicit activity, including creating anonymous companies, opening bank accounts, and advising on real estate purchases for their clients.[7]

Why is the existence of enablers and the money laundering they facilitate so dangerous? Illicit financial flows have significant real-world consequences. Money laundering is understood by U.S. law enforcement not simply to be a question of criminals' accounting, but how the proceeds of crime are turned into new sources of power and activity. "Bad guys have cash that they want to buy things," says James Barnacle. "The only way to do that is to get the money into the banking system to legitimize the proceeds of criminal activity so they can buy goods, products, and services."[8] Barnacle explains that the easier it is to launder money, the more powerful a criminal enterprise grows, be it a drug syndicate, a terrorist group, or a kleptocratic regime. "Obviously the more money the bad guys have," says Barnacle, "the more powerful they become. And you can expand your criminal network if you have the capital to do so. Money buys people--it buys politicians and it buys businessmen."[9]

The weaker the U.S. AML system is, the easier it is for the Mexican Sinaloa Cartel to launder its dirty money, and the quicker it can convert cash from drugs sold on U.S. city streets into new suppliers, new gunmen, and new arms caches. The same rule applies to the kleptocracy of Vladimir Putin's regime. The easier it is for Kremlin kleptocrats to launder their money, the easier it is for them to acquire new foot soldiers, new clients, and new corrupt officials in their pay; while abroad they can acquire new lawyers, new lobbyists, and newly compromised politicians to further their agenda.

As long as the U.S. remains the kleptocrats' favorite laundromat, it is strengthening them and their capacities. In this sense, enablers actively threaten U.S. national security. Although many of the services they provide are legal on the surface, by offering these services to criminals and kleptocrats, these individuals effectively undermine the AML system and enable their clients to freely conduct business with their criminal origins hidden from view.

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[7] "International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation: FATF Recommendations," *Financial Action Task Force,* June 2012-2017.
[8] James Barnacle in discussion with the authors, May 12, 2017.
[9] James Barnacle in discussion with the authors, May 12, 2017.

Kleptocrat Alert

There are two understandings among policymakers that have put the failings of the U.S. AML system on the agenda. The first is the bipartisan consensus that an effective AML system is crucial for fighting terrorism and drugs. Most money laundered in the United States is the proceeds of fraud and drug trafficking that directly impact constituents represented by senators and congressmen.[10] As a result, the link between money laundering and drug cartels is now widely acknowledged in Washington, D.C. There is also an emerging bipartisan understanding that enabling terrorist finance makes them more capable of deadly violence. “Cracking down on terrorist financing, in many ways, ends terrorist activities. Period. End of story,” says Representative Carolyn B. Maloney, Democratic congresswoman for New York’s 12th District.[11]

The second understanding is that kleptocrats pose a threat to U.S. national security. This has been fueled by the political and media fallout of three events. The first was the upswing in Russian aggression which followed Ukraine’s Maidan Revolution in 2014. The second was the media storm following the release of the Panama Papers in 2015 which exposed the offshore schemes used by political elites around the world to hide their wealth. The third was the 2016 U.S. presidential election, which has generated mainstream awareness of kleptocrats and their financial tools.

Former FBI Director Robert Mueller III’s Special Counsel investigation into Russian interference in last year’s election has made kleptocratic influence an urgent issue for Congress. Policymakers are becoming increasingly aware of the Kremlin’s use of corruption as a tool of statecraft. “This is in the Kremlin playbook,” says Sheldon Whitehouse, the Democratic junior Senator for Rhode Island.

This has consolidated a consensus among law enforcement that failures in the U.S. AML system are expanding the power of Russian kleptocrats both at home and abroad. “These large-scale kleptocracies cannot operate unless they have a stable financial market, or access to those markets,” says Darryl Wegner, Chief of the International Corruption Unit at the FBI. “What we are talking about these kleptocrats cannot achieve without accessing these financial powers and abilities.”[12]

Awareness of Russian activities has also helped promote an understanding that enabling international kleptocrats undermines U.S. foreign policy. It is becoming clear to policymakers that money laundering strengthens authoritarian kleptocracies and harms their societies. “In a world where kleptocracy leaves millions and millions of people suffering in poverty, because their countries have been looted by crooked rulers,”

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[10] “National Money Laundering Risk Assessment,” *U.S. Department of the Treasury*, June 12, 2015, https://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/National%20Money%20Laundering%20Risk%20Assessment%20%E2%80%93%2006-12-2015.pdf.
[11] Carolyn Maloney in discussion with the authors, May 17, 2017.
[12] Darryl Wegner in discussion with the authors, May 12, 2017.

says Senator Sheldon Whitehouse, "this enabling both supports and protects those crooked rulers."[13]

It is also widely accepted across the foreign policy community that enabling the finances of kleptocrats both undermines U.S. state building initiatives while undercutting broader development goals. "Kleptocrats abuse us because they're stealing money that we're putting in there in the first place," says Karen Greenaway, Supervisory Special Agent for the FBI's International Corruption Unit. "I would use Afghanistan as an example where we put a ton of rebuilding money there that ended up fueling corruption, and I would use Ukraine as an example as well."[14]

The combination of drugs, terrorism, and Russian electoral interference have lifted long-running financial transparency campaigns led by NGOs such as the Financial Accountability and Corporate Transparency (FACT) Coalition, Global Witness, and Transparency International, to prominence. The enabling of drug cartels, terrorists, and kleptocrats has been brought from the fringes to the center of Washington, D.C.'s debate over U.S. national security. However, while there are now legislative initiatives afoot to limit some of the specific tools enablers can use, substantive reforms addressing the responsibilities of enablers and effectiveness of the AML system as a whole remain as urgent as ever.

[13] Sheldon Whitehouse in discussion with the authors, May 25, 2017.
[14] Karen Greenaway in discussion with the authors, May 12, 2017.

Countering Illicit Finance

Before confronting the political and strategic consequences of flaws in the U.S. approach to fighting illicit finance, we first need to grasp the foundations of the existing AML system to understand how enablers and kleptocrats are incentivized to collude.

What is the AML System?

The United States has the world's most effective 20th century anti-money laundering system: expensive, extensive, but unequipped to deal with the financial flows present in the 21st century. It is designed foremost to stop the money laundering of a 1980s Miami Cocaine Cowboy, and not that of a 2010s Russian kleptocrat.

The United States had no AML system before the twentieth century, as prior to the 1910s, there were neither income taxes nor a prohibition on the sale of recreational drugs.[15] Thus, neither tax evasion nor profiting from drug trafficking existed as financial crimes. "Therefore it is impossible to talk about a rise or a fall of money laundering over the course of the twentieth century," says Jack Blum, former head of the United Nations Experts Group on Asset Recovery and a former investigator for the Senate Committee on Foreign Relations Subcommittee on Narcotics, Terrorism, and International Operations.[16]

The concept of money laundering dates from Prohibition in the 1920s, when the criminalization of alcohol created a need for the profits from its illegal distribution and sale to be concealed.[17] However, the concept that financial flows, rather than just the criminals themselves, could be threatening only became mainstream policy thinking in the 1970s.[18] "There was no concept," says Jack Blum, "that dirty money could utterly distort free markets and even blow up the banking system."[19]

It first became clear to policymakers in the 1970s that the spike in drug trafficking was facilitated by the ease with which traffickers could transform their illicit profits into new sources of power and activity through the banking sector.[20] This realization dovetailed with an understanding among policymakers that these illicit financial flows threatened the integrity of the banking system itself.[21] The scale of these illicit flows could

[15] "History of U.S. Income Tax," *Library of Congress*, 2012, https://www.loc.gov/rr/business/hottopic/irs_history.html.
[16] Jack Blum in discussion with the authors, May 2, 2017.
[17] "Money Laundering," *International Bar Association Anti-Money Laundering Forum*, https://www.anti-moneylaundering.org/money_laundering.aspx.
[18] Sacco, Lisa N., "Drug Enforcement in the United States: History, Policy and Trends," *Congressional Research Service,* October 2014, https://fas.org/sgp/crs/misc/R43749.pdf.
[19] Jack Blum in discussion with the authors, May 2, 2017.
[20] "Appendix C: History of the Bank Secrecy Act," *American Bankers Association*, September 2001, https://www.aba.com/Compliance/Documents/BSA-AppendixC.pdf.
[21] *Ibid.*

potentially cause legitimate financial markets to implode if these sources of financing were suddenly withdrawn.

The United States first began developing an anti-money laundering system in 1970 with the Bank Secrecy Act, which created an extensive reporting system composed of Currency Transaction Reports (CTRs), Reports of International Transportation of Currency or Monetary Instruments (CMIRs), and Reports of Foreign Bank and Financial Accounts (FBARs).[23] The Bank Secrecy Act (BSA) extended anti-money laundering responsibilities to traditional banks, credit unions and thrifts, as well as non-bank financial institutions, securities dealers, and money services businesses.[24] However, enforcement of the BSA was limited until money laundering was finally established as a federal crime in 1986.[25]

A more proactive strategy to combat illicit finance was developed in 1992 by which financial institutions directly assist law enforcement through the filing of Suspicious Activity Reports (SARs).[26] These have become the primary resources used by law enforcement to pursue financial crime.[27] The latest fundamental addition to the AML system was a result Title III of the USA Patriot Act, which, among other provisions, established the requirement for all financial institutions to establish internal anti-money laundering compliance programs.[28]

Although Title III of the USA Patriot Act has greatly strengthened our capabilities to combat money laundering and terrorist financing, substantive change to the AML system has been slow. The result is that a largely 20th century system remains in place, but now operates in a 21st century financial system for which it was not constructed. “Until the 1970s, somebody could bring bags of cash into a bank and there was no paper trail created, and no way to detect what was going on,” says Stefan Cassella, former Deputy Chief of the Justice Department’s Asset Forfeiture and Money Laundering Section.[29] “But what’s changed enormously over the last 30 years is the globalization of the financial institutions, and with it, the globalization of crime,” says Cassella.

The U.S. AML system has not kept pace with the evolution of the financial system and the development of new techniques by financial criminals. “Our AML system has actually driven a lot of illicit finance into more sophisticated means,” says Stefan

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[23] “Appendix C: History of the Bank Secrecy Act,” *American Bankers Association*, September 2001, https://www.aba.com/Compliance/Documents/BSA-AppendixC.pdf.
[24] *Ibid*.
[25] *Ibid*.
[26] “History of Anti-Money Laundering Laws,” *Financial Crimes Enforcement Network*, https://www.fincen.gov/history-anti-money-laundering-laws.
[27] “A New Paradigm: Redesigning the U.S. AML/CFT Framework to Protect National Security and Aid Law Enforcement,” *The Clearing House*, February 2017, https://www.theclearinghouse.org/~/media/TCH/Documents/TCH%20WEEKLY/2017/20170216_TCH_Report_AML_CFT_Framework_Redesign.pdf.
[28] “History of Anti-Money Laundering Laws,” *Financial Crimes Enforcement Network*, https://www.fincen.gov/history-anti-money-laundering-laws.
[29] Stefan Cassella in discussion with the authors, April 26, 2017.

Cassella, "If it's not going to be convenient to just bring cash in anymore because of all these new laws, you are just going to find a new way of doing it."[30]

This is no longer the primarily national, slow-moving, cash and paper-driven U.S. financial system of the 1970s. The 21st century financial system is defined by what has transformed it: the globalization of financial markets, the ubiquity of mass instantaneous money transfers, and the rise of non-bank financial institutions. "The result is we're getting killed," says John Cassara, former Treasury Special Agent. "And we're still getting killed the old-fashioned way because we still haven't secured our system to the old challenges."[31]

Worse still, the weaknesses of the United States' anti-money laundering system are hardly unique. Most democracies operate systems which a similarly flawed, and authoritarian states and kleptocracies have no meaningful anti-money laundering systems whatsoever. The United Nations Office on Drugs and Crime estimates that up to 5 percent of global GDP is laundered money and less than 1 percent of this is ever seized or forfeited.[32] Global Financial Integrity (GFI) estimates that law enforcement fails in 99.9 percent of cases. "Total failure is less than a decimal point away," says Raymond Baker, the President of GFI.[33]

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[30] Stefan Cassella in discussion with the authors, April 26, 2017.
[31] John Cassara in discussion with the authors, May 10, 2017.
[32] "Money-Laundering and Globalization," *United Nations Office on Drugs and Crime*, https://www.unodc.org/unodc/en/money-laundering/globalization.html.
[33] Raymond Baker in discussion with the authors, April 27, 2017.

Four fundamental flaws run through the U.S. anti-money laundering system. The first and most obvious is that anti-money laundering responsibilities do not extend to all of the professional services that act as gatekeepers to the financial system. While extensive though often ineffective reporting requirements are applied to banks, they do not extend to professional firms that offer non-banking financial services such as lawyers, incorporation agents, and those engaged in real estate transactions.[45] This leaves significant professional sectors with almost no deterrents against working as enablers for kleptocrats.

The second flaw is that the United States allows for the creation of anonymous shell companies and for their extensive participation in the economy without their beneficial owners being disclosed. The Department of the Treasury defines a shell company as "a legal entity that is registered with the state, but has no operations or assets."[46] An *anonymous* shell company is one that has "disguised its ownership in order to operate without scrutiny from law enforcement or the public," according to GFI.[47] Once created, anonymous shell companies can be used to hold assets and make financial transactions.[48]

The ease of incorporating an anonymous company in the United States, particularly with the advent of limited liability companies (LLCs), has made the use of these companies mainstream.[49] Though there are legitimate uses for anonymous companies, the veil of secrecy they afford to their owners makes it harder for law enforcement to detect and prevent money laundering activities.[50] "The moment you start an investigation into money, you know that this is going to be an issue," says John Tobon.[51]

The third flaw concerns Suspicious Activity Reports (SARs). These are designed not to prevent potentially illicit money from entering the system, but to create a log for law enforcement when suspicions are aroused.[52] This means that SARs act not as a safeguard for the financial system but as a tracking mechanism. "Once you've taken the

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[45] "United States Mutual Evaluation Report," *Financial Action Task Force*, December 2016, http://www.fatf-gafi.org/media/fatf/documents/reports/mer4/MER-United-States-2016.pdf, 3-4.
[46] "National Money Laundering Risk Assessment," *U.S. Department of the Treasury*, June 12, 2015, https://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/National%20Money%20Laundering%20Risk%20Assessment%20%E2%80%93%2006-12-2015.pdf.
[47] "Anonymous Companies," *Global Financial Integrity*, http://www.gfintegrity.org/issue/anonymous-companies/.
[48] *Ibid*.
[49] Casey Michel, "Raising the Corporate Veil," *Hudson Institute Kleptocracy Initiative*, June 13, 2016, http://kleptocracyinitiative.org/2017/06/raising-the-corporate-veil/.
[50] Belinda Li, "Why Miami Matters," *Hudson Institute Kleptocracy Initiative*, June 26, 2017, http://kleptocracyinitiative.org/2017/06/why-miami-matters/.
[51] John Tobon in discussion with the authors, June 20, 2017.
[52] "FinCen SAR Electronic Filing Instructions," *Financial Crimes Enforcement Network*, October 2012, https://www.fincen.gov/sites/default/files/shared/FinCEN%20SAR%20ElectronicFilingInstructions-%20Stand%20Alone%20doc.pdf.

money, chances are 99,000 out of 99,001 that it will stay in the system," notes Raymond Baker.[53]

The fourth flaw is insufficient law enforcement capacity to establish a meaningful deterrent against facilitating money laundering. Currently, money launderers in the United States face a less than 5 percent risk of conviction and there are only about 2,000 money laundering convictions per year.[54] This is vastly outnumbered by the amount of SARs submitted. According to FinCEN director Jamal El-Hindi's 2017 statement before Congress, FinCEN receives an average of roughly 55,000 new financial institution filings each day.[55] "What this shows is that only a handful are ever investigated," says Baker.[56]

[53] Raymond Baker in discussion with the authors, April 27, 2017.
[54] Peter Reuter and Edwin Truman, *Chasing Dirty Money: The Fight Against Money Laundering*, (Peterson Institute for International Economics, 2004), 187.
[55] "Statement of Jamal El-Hindi, Acting Director of Financial Crimes Enforcement Network United States Department of Treasury Before the Unites States House of Representatives Committee on Financial Services Subcommittee on Terrorism and Illicit Finance", *Financial Crimes Enforcement Network*, April 27, 2017, https://www.fincen.gov/sites/default/files/2017-04/FinCEN%20SFR%20Before%20HFSC%20TIF_20170427_FINAL.pdf.
[56] Raymond Baker in discussion with the authors, April 27, 2017.

The Three Stages of Money Laundering

How does this leave the door open to kleptocrats? To understand how the four fundamental flaws of the U.S. AML system are manipulated by kleptocrats, we need to see them through the eyes of an "enabler." Kenneth Rijock was a lawyer who helped Colombian drug cartels launder their illicit proceeds in the 1980s.[57] After serving a federal prison sentence, Rijock now collaborates with law enforcement on anti-money laundering initiatives.

"Money laundering works in three separate and distinct phases," explains Rijock. "If you can't catch me in the first phase, you are not going to be able to catch me at all. The first phase is placement. This is where you actually take your dirty cash and you somehow get it into the global banking system. The second stage is layering. This is when you obscure the origins of the money behind a complex shield of financial structures. The third phase is integration. This is where the origins of the money have been effectively obscured so you can now invest it."[58]

Placement Loopholes

Both law enforcement and money launderers share this three-step conception of money laundering.[59] "Placement," says Kenneth Rijock, "is where you actually take your dirty cash and put it into a bank, business, or company. It's some means to take the dirty cash on the table and get it into a bank account."[60]

The main method utilized by kleptocrats to place their illicit funds into the financial system is by circumventing the requirement banks have to perform enhanced due diligence on "politically exposed persons" (PEPs).[61] Although revelations of the plundering of state assets by PEPs have led to greater scrutiny of their financial dealings, the World Bank has found that the implementation of relevant international standards is still lacking.[62] The personalized nature of power in a kleptocracy also means that those who benefit from corruption create a powerful constituency that discourages identifying or monitoring of PEP accounts, and may attempt to discredit or silence anti-corruption organizations and leaders.[63]

The World Bank also highlights the increasingly sophisticated methods kleptocrats use to bypass AML controls. Instead of putting funds directly into their own named accounts or those of immediate family members, kleptocrats are now using lesser known

[57] Kenneth Rijock, *The Laundry Man*, (London: Penguin UK, 2013).
[58] Kenneth Rijock in discussion with the authors, May 1, 2017.
[59] "The Money Laundering Cycle," *United Nations Office on Drugs and Crime*, http://www.unodc.org/unodc/en/money-laundering/laundrycycle.html.
[60] *Ibid*.
[61] Defined as senior government officials, their family members and close associates
[62] "Politically Exposed Persons: Preventative Measures for the Banking Sector," *World Bank*, 2010, https://star.worldbank.org/star/sites/star/files/Politically%20Exposed%20Persons_0.pdf.
[63] *Ibid*.

associates and more complex corporate arrangements to conceal their assets.[64] This means that banks now need more innovative ways to monitor PEP activity, and professionals, such as lawyers who specialize in creating complex corporate arrangements, need to be more vigilant of PEPs enlisting their services.

The second loophole involves anonymous companies used for placement. Until recently, companies, also known as legal entity customers, could open bank accounts without having to reveal their beneficial owners. FinCEN's Customer Due Diligence (CDD) Rule, effective July 2016, requires banks to determine the beneficial owners of new client accounts.[65] Any individual controlling 25 percent or more of the equity interests of a legal entity customer is defined as a beneficial owner.[66]

This rule signifies substantial progress by the Department of Treasury in ending the abuse of anonymous shell companies, but significant loopholes remain for two reasons. First, a person with no legal ownership of the company can be the primary beneficiary of its existence without actually holding an equity stake. Although FinCEN has extended the term "beneficial owner" to apply to a single individual with significant responsibility to control, manage, or direct the legal entity, an executive officer or senior manager or any other individual with managerial responsibilities can fulfill this position without being the one who ultimately benefits from the existence of the legal entity. "The current definition of beneficial owner in the CDD rule needs to be expanded," says Heather Lowe, Legal Counsel for Global Financial Integrity, "to include those who control a company through unofficial means. Otherwise, the new CDD will be easy to circumvent."[68]

Second, banks are not incentivized to verify beneficial ownership information, nor do they have the resources to do so. As noted by FinCEN, after soliciting comments from financial institutions, "many commenters noted the practical difficulties resulting from the fact that there is no authoritative source for beneficial ownership information of legal entities, as there is no requirement for U.S. States to collect this information at the time a company is formed."[69] Furthermore, FinCEN has stated that financial institutions can rely on beneficial ownership information supplied by the customer, provided that they have no knowledge of facts that would reasonably call into question the reliability of the information.[70] Without the need for any outside verification, criminals and kleptocrats can supply misleading information with little risk of detection.

The third loophole kleptocrats use to place their funds into the U.S. financial system involves the lack of due diligence requirements placed on lawyers. Because lawyers are not required to screen their clients for money laundering concerns, kleptocrats can

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[64] *Ibid.*
[65] "Customer Due Diligence Requirements for Financial Institutions: Final Rules," *Financial Crimes Enforcement Network*, May 2016, https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf.
[66] *Ibid.*
[68] Heather Lowe in discussion with the authors, May 26, 2017.
[69] "Customer Due Diligence Requirements for Financial Institutions: Final Rules," *Financial Crimes Enforcement Network*, May 2016, https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf.
[70] *Ibid.*

utilize lawyers to bypass both AML and PEP controls when setting up bank accounts and making purchases.[71] This is a key vulnerability to the AML system because information about the sources of funds placed into law firm accounts is protected by attorney-client privilege.[72]

Although client funds are sometimes placed in individual trust accounts which are subject to AML screening, clients' funds can also be lumped together in pooled bank accounts known as Interest On Lawyer Trust Accounts (IOLTA), and their sources of funds are not revealed to banks.[73] IOLTAs are not subject to mandatory reporting requirements, which allows, among other things, cash deposits and withdrawals over $10,000 to go undetected.[74]

More importantly, these funds can be sent from law firm accounts to other accounts elsewhere in the financial system. Because IOLTAs are used to hold client money for pending transactions, such as real estate deals, funds can be sent from these accounts to other parties at the client's request. Up to $400 billion runs through these accounts every year, often linked to luxury real estate purchases.[75] "All the banks see on the accounts is the law firm's name on it," says Peter Henning, professor of law at Wayne State University. "99 percent of the accounts are probably used for legitimate means, but it's the one percent that can lead to billions of dollars being laundered."[76]

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[71] "Keeping Foreign Corruption Out of the United States: Four Case Histories," *Senate Homeland Security Committee's Permanent Subcommittee on Investigations*, 2010, 15-16.
[72] "ABA scores wins on attorney-client privilege and independence of the legal profession," *American Bar Association*, March 2017, http://www.abajournal.com/magazine/article/attorney_confidentiality_fdic_treasury_labor.
[73] "Bank Secrecy Act Anti-Money Laundering Examination Manual: Professional Service Providers," *Federal Financial Institutions Examination Council*, https://www.ffiec.gov/bsa_aml_infobase/pages_manual/OLM_093.htm.
[74] "Third Party Money Launderers," *U.S. Department of Homeland Security Immigration and Customs Enforcement*, https://www.ice.gov/sites/default/files/documents/Report/2017/CSReport-13-4.pdf, 1-2.
[75] Rachel Ensign and Serena Ng, "Law Firms' Accounts Pose Money Laundering Risks," *Wall Street Journal*, https://www.wsj.com/articles/law-firms-accounts-pose-money-laundering-risk-1482765003.
[76] Peter Henning in discussion with the authors, August 28, 2017.

Layering Loopholes

Layering is the second stage of money laundering. This is the process through which the placement of illicit funds is concealed by creating a web of complex financial transactions. "This is where you take your money that's already in the financial system," says Kenneth Rijock, "and you transfer it through multiple bank secrecy jurisdictions so that it not only loses its original taint but also becomes next to impossible for any investigator to follow the trail."[77]

The primary loophole used for layering in the United States is the ability to create an anonymous shell company. "It's been a constant for my entire career," says John Tobon. "Shells are the criminals' preferred vehicles for concealing illicit activity, whether you are kleptocrat or a drug dealer or every criminal in between."[78]

Kleptocrats are able to engage in transactions in the United States using anonymous shell companies owned by interlocking chains of other anonymous shell companies based in dozens of increasingly remote locations. "Criminals can set up companies in multiple offshore jurisdictions," says John Tobon, "And these companies are owned by others that are created in other secrecy jurisdictions. That's a red flag because complex schemes like these are not necessary for privacy."[79]

The proliferation of anonymous shell companies domestically and abroad has made it easier for criminals to obscure the sources of illicit funds. "Shell companies are a vulnerability for us," said James Barnacle, "because it allows a layering of transactions that makes it difficult for us to uncover. International registration of such entities is also difficult for us because it transcends national borders. You can drive a car across Europe and go from country to country to country, but when I work in law enforcement, those geographical borders impact what I can do. I have to go through foreign law enforcement, letters of rogatory, and ambassadors and embassies to get the information I need."[80]

Despite some states requiring more information than others, anonymous shell companies can be created in any state in the U.S.[81] It currently takes more information to obtain a library card than to form a U.S. company; in fact, a recent study showed that it was easier to create an anonymous company in the U.S. than anywhere else in the world.[82] The U.S. produces more than 2 million corporate entities per year, pumping out

[77] Kenneth Rijock in discussion with the authors, May 1, 2017.
[78] John Tobon in discussion with the authors, June 20, 2017.
[79] John Tobon in discussion with the authors, June 20, 2017.
[80] James Barnacle in discussion with the authors, May 12, 2017.
[81] "Report to the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate - Company Formations: Minimal Ownership Information Is Collected and Available," *Government Accountability Office*, April 2006, http://www.gao.gov/new.items/d06376.pdf.
[82] "FACT Sheet: Anonymous Shell Companies Enabling Criminal Activity in the U.S. and Around the World," *Financial Accountability and Corporate Transparency (FACT) Coalition*, August 2017, https://thefactcoalition.org/fact-sheet-anonymous-shell-companies-august-2017?utm_medium=policy-analysis/fact-sheets; Michael Findley, Daniel Nielson and J.C. Sharman, *Global Shell Games:*

10 times more such shell companies than the world's other 41 tax havens combined.[83] U.S. incorporation companies were also the most willing to set up untraceable shell companies in a study where researchers posed as money launderers, corrupt officials, and terrorist financiers.[84]

The majority of U.S. anonymous shell companies are incorporated in states like Delaware and Nevada, which specialize in ensuring as little incorporation regulation as possible.[85] There are also online incorporation services, which make it extremely cheap and easy to incorporate from anywhere around the world.[86] "I don't think there is a single legislature in the world," says John Tobon, "that has kept up with the speed at which technology has leapt forward as regards to online financial abilities, from simply being able to check your balance to now being able to instantly create a company and move funds into it."[87]

Although any company can have its beneficial owner anonymized, single member Limited Liability Companies (LLCs) are both the easiest to incorporate and the easiest to manipulate, as they require no additional inputs such as regular minute-taking or boards of directors. "You can have a single-member LLC, and that was a catastrophic mistake," says Jack Blum.[88] "Before the 1990s, you needed to have a regular meeting of a board of directors, minutes, reporting—but this was all junked. We've had a straight-line degradation of the law surrounding corporate responsibility."

Why is the anonymous companies loophole so embedded? In the United States, incorporation takes place under state laws without the direct involvement of the federal government.[89] As a result, some U.S. states have pursued competitive incorporation policies to attract tax and fee revenue. "These circumstances have encouraged a race to the bottom," remarks Susan Hamill, a professor of law at University of Alabama, "where state lobbyists have pushed state governments to dilute regulations or face losing these revenues."[90]

Delaware, where 66 percent of actively traded U.S. companies are incorporated, earns more than $1 billion a year from incorporation fees—representing more than a third of

Experiments in Transnational Relations, Crime, and Terrorism, (Cambridge University Press, 2014), 74, http://bit.ly/2uTLptQ.

[83] "Puppet Masters: How the Corrupt Use Legal Structures to Hide Stolen Assets and What to Do About It," *World Bank Publications: Stolen Asset Recovery Initiative*, https://star.worldbank.org/star/publication/puppet-masters.

[84] Michael Findley, Daniel Nielson and J.C. Sharman, *Global Shell Games: Experiments in Transnational Relations, Crime, and Terrorism*, (Cambridge University Press, 2014), 74, http://bit.ly/2uTLptQ.

[85] Casey Michel, "The U.S. Is a Good Place for Bad People to Stash Their Money," *The Atlantic*, July 13, 2016, https://www.theatlantic.com/business/archive/2017/07/us-anonymous-shell-companies/531996/.

[86] *Ibid*.

[87] John Tobon in discussion with the authors, June 20, 2017.

[88] Jack Blum in discussion with the authors, May 2, 2017

[89] Casey Michel, "Raising the Corporate Veil," *Hudson Institute Kleptocracy Initiative*, June 13, 2016, http://kleptocracyinitiative.org/2017/06/raising-the-corporate-veil/.

[90] Susan Hamill in discussion with authors May 24, 2017.

the state's annual revenue.[91] This has become the source of intense resistance to reform. Since the first bill to call for the disclosure of beneficial ownership was introduced in 2006 by Carl Levin, a former Democratic Senator for Michigan, at least three similar bills have been killed in Congress. "The reason these bills died was because up until recently, the business community and some of the states were opposed to reform," says Gary Kalman, Executive Director of the Financial Accountability and Corporate Transparency (FACT) Coalition.[92]

[91] David Kocieniewski, "Delaware's 1 Billion Incorporation Machine," *Bloomberg News*, April 27, 2016, https://www.bloomberg.com/news/articles/2016-04-27/delaware-s-1-billion-opacity-industry-gives-u-s-onshore-haven.

[92] Gary Kalman in discussion with the authors May 15, 2017.

Integration Loopholes

"Integration," says Kenneth Rijock, "is where you can invest and use the illicit money in a seemingly legitimate way, because the origin of the money has now been effectively obscured."[93] One of the primary loopholes for integration used by kleptocrats is purchase of real estate.

Recent cases prosecuted by the Department of Justice's Kleptocracy Asset Recovery Initiative illustrate the popularity of U.S. real estate among kleptocrats and their families. Chen Shui-bian, the former President of Taiwan, was found to have bought $2.1 million worth of U.S. property with the proceeds of bribes given to his family members.[94] Pavlo Lazarenko, the former prime minister of Ukraine currently under investigation by the Department of Justice for laundering $271 million in corruption proceeds, previously owned the largest home in Marin County, which was worth more than $5 million.[95] Jianjun Qiao, a former government official in China who transferred about $4 million in embezzled funds from China to banks in the U.S., allegedly owned $28 million of property in California's San Gabriel Valley under the name of his ex-wife.[96] All of these properties were bought under the names of LLCs.

The popularity of the real estate loophole may be partly attributed to the fact that the real estate sector is not effectively covered by the U.S. AML system.[97] This loophole for integration has long been recognized by the Department of the Treasury, but efforts to close it have failed. In 2001, the USA Patriot Act required financial institutions regulated under the Bank Secrecy Act, including professionals involved in real estate closings, to perform customer due diligence and undergo compliance training.[98] However, in 2002, real estate professionals were temporarily exempted from the Patriot Act's AML requirements and have remained so ever since.[99]

"It is a mystery to most of the folks fighting money laundering about why there hasn't been a repeal of the so-called 'temporary' exemption given to the real estate industry

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[93] Kenneth Rijock in discussion with the authors, May 1, 2017.
[94] "U.S. Forfeits $2.1 Million Worth of Property Purchased with Alleged Bribes Paid to the Family of the Former President of Taiwan," *U.S. Department of Justice*, November 14, 2012, https://www.justice.gov/opa/pr/us-forfeits-21-million-worth-property-purchased-alleged-bribes-paid-family-former-president.
[95] Leslie Wayne, "A Ukrainian Kleptocrat Wants His Money and U.S. Asylum," *New York Times*, July 6, 2016, https://www.nytimes.com/2016/07/07/business/international/a-ukrainian-kleptocrat-wants-his-money-and-us-asylum.html.
[96] Frank Shyong, "Ex-wife of fugitive Chinese official will forfeit millions of dollars worth of San Gabriel Valley property in visa fraud case," *Los Angeles Times*, January 11, 2017, http://www.latimes.com/local/lanow/la-me-ln-wife-fugitive-chinese-20170110-story.html.
[97] "Advisory to Financial Institutions and Real Estate Firms and Professionals," *Financial Crimes Enforcement Network*, August 22, 2017, https://www.fincen.gov/sites/default/files/advisory/2017-08-22/Risk%20in%20Real%20Estate%20Advisory_FINAL%20508%20Tuesday%20%28002%29.pdf.
[98] "Anti-Money Laundering Program Requirements for 'Persons Involved in Real Estate Closings and Settlements'," *Financial Crimes Enforcement Network*, https://www.treasury.gov/press-center/press-releases/Documents/js1751.pdf.
[99] "Treasury Department USA Patriot Act Update," *U.S. Department of Treasury*, October 25, 2002, https://www.treasury.gov/press-center/press-releases/Pages/po3034.aspx.

back in 2002," says Elise Bean, former Staff Director and Chief Counsel of the U.S. Senate Permanent Subcommittee on Investigations, which conducted investigations showing how U.S. real estate was used to launder suspect funds.[100] "The evidence of money laundering through U.S. real estate is staggering," she adds.

The purported purpose of the temporary exemption was to allow Treasury and FinCEN to study the affected industries and to consider the effects of applying AML to them.[101] However, many remember an intense lobbying campaign by the real estate sector. "You have to remember the real estate lobby," says Jack Blum, "unlike any other lobby, is present in every single congressional district."[102]

The loophole has not yet been closed but thirteen years later, the Department of the Treasury finally possesses the research needed to make a definitive case for reform.[103] In August 2017, FinCEN issued an advisory stating that "drug traffickers, corrupt officials, money launderers, and other criminals seek to exploit real estate transactions to hide their illicit profits, conceal their identities, and launder funds."[104] This was on the back of almost two years of expanding data gathering on the real estate loophole.

In 2016, FinCEN issued Geographic Targeting Orders (GTOs) that require title insurance companies to identify the beneficial owners of anonymous shell companies buying real estate in cash in certain jurisdictions.[105] The results showed that 30 percent of transactions caught under the GTO scheme involved a buyer who had triggered a SAR in the past.[106] Since then, GTOs have been extended for a further year, expanded to more cities across the U.S., and, crucially, amended to include wire transfers.[107]

However, because GTOs are only intended to gather data, they remain a temporary pilot scheme and do little to close the loopholes themselves. Additionally, GTOs only apply to certain jurisdictions and one can avoid detection by purchasing multiple properties below the designated cash thresholds.

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[100] Elise Bean in discussion with the authors, June 20, 2017.
[101] "Treasury Department USA Patriot Act Update," *U.S. Department of Treasury*, October 25, 2002, https://www.treasury.gov/press-center/press-releases/Pages/po3034.aspx.
[102] Jack Blum in discussion with the authors, May 2, 2017.
[103] "Advisory to Financial Institutions and Real Estate Firms and Professionals," *Financial Crimes Enforcement Network*, August 22, 2017, https://www.fincen.gov/sites/default/files/advisory/2017-08-22/Risk%20in%20Real%20Estate%20Advisory_FINAL%20508%20Tuesday%20%28002%29.pdf.
[104] "Advisory to Financial Institutions and Real Estate Firms and Professionals," *Financial Crimes Enforcement Network*, August 22, 2017, https://www.fincen.gov/sites/default/files/advisory/2017-08-22/Risk%20in%20Real%20Estate%20Advisory_FINAL%20508%20Tuesday%20%28002%29.pdf.
[105] "Geographic Targeting Order," *Financial Crimes Enforcement Network*, July 22, 2016, https://www.fincen.gov/sites/default/files/shared/Title_Ins_GTO_Sample_072716.pdf.
[106] "FinCEN Renews Real Estate 'Geographic Targeting Orders' to Identify High-End Cash Buyers in Six Major Metropolitan Areas," *Financial Crimes Enforcement Network*, February 23, 2017, https://www.fincen.gov/news/news-releases/fincen-renews-real-estate-geographic-targeting-orders-identify-high-end-cash.
[107] "FinCEN Targets Shell Companies Purchasing Luxury Properties in Seven Major Metropolitan Areas," *Financial Crimes Enforcement Network*, August 22, 2017, https://www.fincen.gov/news/news-releases/fincen-targets-shell-companies-purchasing-luxury-properties-seven-major.

These prevailing loopholes mean that significant illicit financial flows may still be entering the United States undetected. Every year, more than $100 billion flows into the U.S. real estate market from abroad—half of it in cash.[108] Meanwhile, in the last quarter of 2015, 58 percent of all U.S. property purchases of more than $3 million were made by limited liability corporations.[109] Altogether, those transactions totaled $61.2 billion. "The problem is not real estate," says John Tobon. "The problem is the lack of beneficial ownership information available regarding anonymous shell companies, because the money is not parked in real estate *per se*, but parked in an anonymous financial vehicle. That is what allows those illicit funds to be parked in plain view."[110]

[108] "2016 Profile of International Activity in U.S. Residential Real Estate," *National Association of Realtors*, June 2016, pg. 3-4.
[109] Ana Swanson, "How secretive shell companies shape the U.S. real estate market," *The Washington Post*, April 12, 2016, https://www.washingtonpost.com/news/wonk/wp/2016/04/12/how-secretive-shell-companies-shape-the-u-s-real-estate-market/?utm_term=.f534108000d0.
[110] John Tobon in discussion with the authors, June 20, 2017.

The Enablers' System

When one traces the flow of dark money through these loopholes, a parallel non-bank centered financial system circumventing the existing AML system becomes apparent. In this system, lawyers take on the function of bankers, anonymous companies are treated like bank accounts, and luxury real estate becomes almost a currency. "Typically what happens," says Peter Zalewski, a real estate analyst and Principal at Condo Vultures, "is the illicit funds are wired into an account belonging to law firm. That law firm typically sets up an LLC with an address in the United States. The law firm attorney will typically be a registered incorporation agent, so he will be the only one who knows the beneficial owner. Then the LLC will buy a condo."[111]

Because kleptocrats are increasingly keen on using complex corporate arrangements to conceal the ownership of their assets, lawyers have become an integral part of the placement and layering processes. In 2010, the Senate Committee on Homeland Security and Governmental Affairs investigated how several foreign kleptocrats moved their assets into the United States. The investigations into Teodoro Obiang, the son of the president of Equatorial Guinea, revealed that two lawyers proactively helped Obiang bypass AML controls and move more than $5 million of suspect funds into the U.S.[112] According to the report, "Both attorneys were aware of the allegations of corruption related to Mr. Obiang, but facilitated his efforts to use shell company, attorney-client, law office, and other third party accounts at six U.S. banks as hidden conduits for his funds."[113] In return for their services, the lawyers were paid as much as $196,000.[114]

Lawyers have also become crucial facilitators in the integration phase, due to their involvement in real estate closings. In one recent case, where approximately $540 million in assets was stolen from a Malaysian sovereign wealth fund, 1Malaysia Development Berhad (1MDB), and laundered in the United States, 1MDB's board allegedly transferred hundreds of millions from their accounts to a pooled account of a top tier U.S. law firm, Shearman & Sterling LLP, and used money from the law firm's pooled account to buy luxury real estate, including a mansion in Beverly Hills.[115] According to the complaint, the mansion was bought by a Nevada registered company using an attorney from the law firm as a signatory.[116]

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[111] Peter Zalewski in discussion with the authors, May 2, 2017.
[112] "Keeping Foreign Corruption Out of the United States: Four Case Histories," *U.S. Senate Committee on Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations*, February 4, 2010.
[113] *Ibid*, pg. 26.
[114] *Ibid*.
[115] "U.S. Seeks to Recover Approximately $540 Million Obtained From Corruption Involving Malaysian Sovereign Wealth Fund," *U.S. Department of Justice*, June 15, 2017, https://www.justice.gov/opa/pr/us-seeks-recover-approximately-540-million-obtained-corruption-involving-malaysian-sovereign.
[116] USA v. "The Wolf of Wall Street" Motion Picture, Including Any Rights to Profits, Royalties and Distribution Proceeds," No. CV 16-16-5362, Complaint, July 20, 2016, http://www.wsj.com/public/resources/documents/1MDB-Filing-07-20-2016.pdf.

Real estate agents are also important in the kleptocrats' system. Because they are not subject to customer due diligence requirements, real estate agents can advise clients on real estate deals without knowing the intentions behind the transactions. "You don't care and you're not incentivized to care. You have no reason to care. Because again, there's no sheriff in town to bust balls," says Peter Zalewski.[117]

During the 2010 investigations into Teodoro Obiang, it was revealed that one real estate agent received a $305,000 commission after helping Teodoro Obiang buy his $30 million mansion in Malibu and another real estate agent earned a $308,000 commission after helping him sell a Los Angeles residence for $7.7 million.[118] When asked whether he had any suspicions about Obiang's source of funds, the realtor who helped Obiang buy his Malibu mansion stated that he never asked his clients questions about their finances, since he had no legal obligation to do so and such questions made most clients uncomfortable.[119]

Protecting the anonymity of clients is undisputedly important for realtors who specialize in facilitating luxury real estate deals. In a *New York Times* piece on the anonymous ownership of luxury properties in New York City, the real estate agents interviewed all agreed that commitment to anonymity is essential for their profession.[120] "One thing about being a high-end broker is—we have to protect the privacy of our clients," said Hall F. Willkie, president of Brown Harris Stevens. "If we didn't, we wouldn't have them as clients. We're very much like private bankers in that sense."[121]

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117 Peter Zalewski in discussion with the authors, May 2, 2017.

118 "Keeping Foreign Corruption Out of the United States: Four Case Histories," *U.S. Senate Committee on Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations*, February 4, 2010.

119 *Ibid*, pg. 80.

120 Louise Story and Stephanie Saul, "Stream of Foreign Wealth Flows to Elite New York Real Estate," *New York Times*, February 7, 2015, https://www.nytimes.com/2015/02/08/nyregion/stream-of-foreign-wealth-flows-to-time-warner-condos.html?rref=collection%2Fnewseventcollection%2Fshell-company-towers-of-secrecy-real-estate&action=click&contentCollection=us&region=rank&module=package&version=highlights&contentPlacement=1&pgtype=collection.

121 *Ibid*.

The Case for Regulation

To counter the rise in non-bank centered financial systems, leading authorities on AML argue that we need to develop a new understanding of the nature of illicit finance. "There is a theory that at the end of the day the financial system is fundamentally based on the banks," says Chip Poncy, former Director of the Office of Strategic Policy for Terrorist Financing and Financial Crimes and a former Senior Advisor at the U.S. Department of the Treasury, "but we need to reject that theory as a global community."[122]

The first step in countering illicit finance outside of the traditional banking system is to recognize that the gatekeepers to this alternate financial system— the luxury real estate developers who supply and market their properties to kleptocrats, real estate agents who sell the "anonymity" of U.S. real estate, and lawyers who take on the roles of bankers and financial handlers—must be regulated. In 2012, the Financial Action Task Force (FATF), an intergovernmental body tasked with coordinating international efforts to combat money laundering, issued 40 recommendations which are recognized as the international standard for AML regulations.[123] Included in this document were several recommendations that pertained to lawyers, incorporation agents, real estate professionals, and other "designated non-financial businesses and professions" (DNFBPs).[124]

Although the U.S. is one of the founding members of FATF, it has implemented none of the recommendations regarding DNFBPs. In its 2016 Mutual Evaluation of United States, FATF deemed the U.S. to be non-compliant on all of the recommendations regarding the customer due diligence requirements and regulation and supervision of these businesses and professions.[125] According to the FATF evaluation, "Other than the customer identification and record-keeping requirements associated with the filing of Form 8300 (for transactions exceeding $10,000 in cash), broader AML/CFT requirements have not been extended to any category of DNFBP, other than casinos and dealers in precious metals and stones."[126] Due to their involvement in creating legal structures and facilitating high-end real estate transactions, FATF notes that this exclusion of lawyers, company formation agents, and real estate agents presents a "significant risk" to the financial system.[127]

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[122] Chip Poncy in discussion with the authors, July 5, 2017.
[123] "International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation: The FATF Recommendations," *Financial Action Task Force*, February 2012, http://www.fatf-gafi.org/publications/fatfrecommendations/documents/fatf-recommendations.html.
[124] *Ibid*.
[125] "Anti-money Laundering and Counter-terrorist Financing Measures: United States Mutual Evaluation Report," *Financial Action Task Force*, December 2016, http://www.fatf-gafi.org/publications/mutualevaluations/documents/mer-united-states-2016.html.
[126] *Ibid*, pg. 234.
[127] *Ibid*, pg. 220-222, 235.

The Scope of Federal Regulations

Much of the resistance to AML regulation in these industries rests on the argument that such regulation is unnecessary, given current prohibitions against the facilitation of money laundering. However, a closer examination of the current AML regime reveals key weaknesses.

The main deterrent against facilitating money laundering is the Money Laundering Control Act, which is intentionally broad in scope. However, despite its broad definition of money laundering, its principal provisions require prosecutors to prove that defendants had knowledge that funds in evidence were derived from some criminal activity.[128] In the absence of customer due diligence requirements for key industries, this requirement is nearly impossible to fulfill. "To the extent that you can maintain an arm's-length relationship with your client and simply restrict yourself to fairly narrow transactional steps then you're going to be pretty much immune to any of the ethics rules or allegations of criminal conduct," states Peter Henning.[129]

Lawyers, incorporation agents, and real estate professionals are also prohibited from doing business with individuals and companies sanctioned by the Office of Foreign Assets Control (OFAC).[130] However, many kleptocrats who use their illicit wealth to hire lobbyists and PR firms are not recognized as criminals until millions of dollars have been plundered from their home countries and safely hidden in the United States. The governments of Equatorial Guinea and Uzbekistan, for example, spent millions of dollars to hire U.S. lobbying firms while illegal funds were being pocketed by their leaders' children.[131] Kleptocracies have also been active in hiring lobbying firms to weaken or prevent sanctions.[132]

Additionally, all professions must file a Form 8300 report with the Internal Revenue Service if cash payments of $10,000 or more are received.[133] Although the reports are intended to assist law enforcement in its AML efforts by providing an audit trail, the ability of the IRS to fully utilize the information collected is questionable. Arthur Vandesande, a retired IRS Criminal Investigation Special Agent, notes that between 1995 and 2006, the number of agents working for the IRS Criminal Division was cut by

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[128] 18 U.S.C. § 1956 and 18 U.S.C. § 1957
[129] Peter Henning in discussion with the authors, August 28, 2017.
[130] "Office of Foreign Assets Control—Overview," *Federal Financial Institutions Examination Council*, https://www.ffiec.gov/bsa_aml_infobase/pages_manual/olm_037.htm.
[131] Leslie Wayne, "Shielding Seized Assets From Corruption's Clutches," *New York Times*, December 30, 2016, https://www.nytimes.com/2016/12/30/business/justice-department-tries-to-shield-repatriations-from-kleptocrats.html.
[132] Megan R. Wilson, "Sudan Sanctions Spur Intense Lobbying," *The Hill*, July 19, 2017, http://thehill.com/business-a-lobbying/business-a-lobbying/342632-sudan-sanctions-spur-intense-lobbying.
[133] "Form 8300 and Reporting Cash Payments of Over $10,000," *Internal Revenue Service*, https://www.irs.gov/businesses/small-businesses-self-employed/form-8300-and-reporting-cash-payments-of-over-10000.

one-third. “The less personnel the IRS has, the less audits there will be. And in a voluntary system, that means more people are going to cheat,” Vandesande remarks.[134]

Clearly, current federal prohibitions against facilitating money laundering are not strong enough to deter profit-seeking individuals from colluding with kleptocrats. Because this risk in the banking community was recognized by policymakers, the U.S. requires banks and other financial institutions to establish internal anti-money laundering programs to detect and report suspicious transactions to law enforcement.[135] But the legal, incorporation, and real estate professions are not covered by similar requirements.

[134] Arthur Vandesande in discussion with the authors, May 2, 2017.
[135] Public Law 107–56

The Limits of Self-Regulation

Without clearly defined anti-money laundering responsibilities, these industries rely on professional associations and established norms to self-regulate. However, this has serious limitations due to its over-reliance on voluntary guidelines and lack of enforcement.

Lawyers, for example, are regulated by state courts and bar associations. State regulations are guided by the "Model Rules of Professional Conduct" published by the American Bar Association (ABA).[136] In relation to money laundering, Model Rule of Professional Conduct 1.2(d) says that a lawyer should "not counsel a client to engage, or assist a client in conduct that the lawyer knows is criminal or fraudulent."[137] However, similar to the Money Laundering Control Act, this language emphasizes that the lawyer must have knowledge of the crime, which is difficult to prove and far too easy to challenge. Peter Henning states, "Many lawyers are expert at keeping themselves ignorant about exactly what is taking place to maintain plausible deniability. Moreover, that same rule [Model Rule of Professional Conduct 1.2(d)] says that 'a lawyer may discuss the legal consequences of any proposed course of conduct,' so exploring the limits of the law can be permissible."[138]

The American Bar Association also issued "Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing" in 2010[139] and "A Lawyer's Guide to Detecting and Preventing Money Laundering" in 2014.[140] Voluntary guidelines, however, have their limitations. Heather Lowe notes, "The Guidelines are very good, but the problem with them is that they're voluntary. If you were to walk along K Street and ask lawyers if they've ever seen these guidelines before, I think the number of lawyers who can truthfully say yes will be fairly low."[141]

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[136] "Model Rules of Professional Conduct", American Bar Association, https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct.html.

[137] "Rule 1.2: Scope of Representation & Allocation of Authority Between Client & Lawyer," *American Bar Association*, https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_2_scope_of_representation_allocation_of_authority_between_client_lawyer.html.

[138] Peter Henning, "Panama Papers Show How Lawyers Can Turn a Blind Eye," *New York Times*, April 11, 2016, https://www.nytimes.com/2016/04/12/business/dealbook/panama-papers-show-how-lawyers-can-turn-a-blind-eye.html?mcubz=1.

[139] "Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing", *American Bar Association*, April 23, 2010, https://www.americanbar.org/content/dam/aba/publishing/criminal_justice_section_newsletter/crimjust_taskforce_gtfgoodpracticesguidance.authcheckdam.pdf.

[140] "A Lawyer's Guide to Detecting and Preventing Money Laundering", American Bar Association, October 2014, https://www.americanbar.org/content/dam/aba/uncategorized/GAO/2014oct_abaguide_preventingmoneylaundering.authcheckdam.pdf.

[141] Heather Lowe in discussion with the authors, May 26, 2017.

Voluntary anti-money laundering guidelines have also been issued by the National Association of Realtors (NAR), which represents over 1.2 million real estate professionals in the United States. The four-page document, titled "Anti-Money Laundering Guidelines for Real Estate Professionals," was published in 2012.[142] Like the guidelines put forth by the ABA, the effectiveness of these voluntary guidelines in promoting knowledge of AML issues is debatable.

For example, while the guidelines emphasize the importance of customer due diligence for AML purposes, most real estate agents only screen clients to determine their financial status. Lynda Fernandez, the senior vice president of public relations at the Miami Association of Realtors remarks, "Realtors normally get information just for their own personal security, and they get prequalification for mortgages before they go out and work with someone."[143] Elizabeth Sample, the real estate agent on the Time Warner deal with Vitalny Malkin, remarked to *New York Times* reporter Louisa Story in 2015, "They have to have the money. Other than that, that's it. That's all we need."[144]

NAR's voluntary guidelines also highlight the possible negative repercussions of filing SARs for realtors. The guide states, "It is important to note that while the Bank Secrecy Act contains a safe harbor shielding financial institutions from civil liability in connection with the filing of a SAR, there is no precedent to suggest that the safe harbor would extend beyond financial institutions to real estate professionals. Therefore, a real estate agent should be prudent and file a suspicious activity report only after thoroughly evaluating the circumstances surrounding the suspicious activity, and additionally should consider consulting an attorney on the matter prior to filing a SAR. Otherwise, a real estate agent could subject themselves to civil liability as a result."[145] Thus, even though realtors are able to file suspicious activity reports, there are likely few that would assume such a seemingly onerous responsibility.

Incorporation agents, also known as company service providers, do not have a professional association and are very loosely regulated. According to a 2010 FATF report, U.S. company service providers are not required to be licensed, and are only required to be registered with the Secretary of State's office in two states.[146]

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142 "Anti-Money Laundering Guidelines for Real Estate Professionals," *National Association of Realtors*, November 15, 2012, https://www.nar.realtor/articles/anti-money-laundering-guidelines-for-real-estate-professionals.
143 Lynda Fernandez in discussion with the authors, May 2, 2017.
144 Louise Story and Stephanie Saul, "Stream of Foreign Wealth Flows to Elite New York Real Estate," *New York Times*, February 7, 2015, https://www.nytimes.com/2015/02/08/nyregion/stream-of-foreign-wealth-flows-to-time-warner-condos.html?rref=collection%2Fnewseventcollection%2Fshell-company-towers-of-secrecy-real-estate&action=click&contentCollection=us&region=rank&module=package&version=highlights&contentPlacement=1&pgtype=collection.
145 "Anti-Money Laundering Guidelines for Real Estate Professionals," *National Association of Realtors*, November 15, 2012, https://www.nar.realtor/articles/anti-money-laundering-guidelines-for-real-estate-professionals.
146 "Money Laundering Using Trust and Company Service Providers," *Financial Action Task Force*, October 2010, http://www.fatf-gafi.org/media/fatf/documents/reports/Money%20Laundering%20Using%20Trust%20and%20Company%20Service%20Providers..pdf.

Furthermore, those two states are the only ones that require supervision and monitoring of company service providers, and this oversight only applies to their general conduct of business, as opposed to AML/CFT compliance specifically.[147]

[147] *Ibid*, pg. 64.

The State of Reform

Resistance from professional associations is a large factor in why the U.S. has not extended AML responsibilities to these industries, despite being rated "non-compliant" by FATF.

In 2002, the American Bar Association created the Gatekeeper Task Force, which has consistently opposed legislation that would impose "burdensome and intrusive" gatekeeper regulations on lawyers.[148] ABA has argued that legislation such as the Corporate Transparency Act would "undermine the traditional role of state courts in regulating lawyers, erode the attorney-client privilege and interfere with the confidential attorney-client relationship, impose excessive new federal regulations on lawyers engaged in the practice of law, and impinge on the delivery of legal services in general."[149]

Similarly, the National Association of Realtors (NAR) has maintained the position that "Regulations that would require real estate agents and brokers to adopt anti-money laundering programs would prove burdensome and unnecessary given the existing AML/TF regulations that already apply to United States financial institutions."[150] The National Association of Secretaries of State (NASS) has consistently opposed extending beneficial ownership disclosure requirements to the incorporation industries on the grounds that such legislation is "unnecessary," "won't stop criminals," and would "create more red tape."[151]

However, there seems to be a growing possibility for change. Those who oppose legislation that would extend AML or customer due diligence responsibilities to the legal profession view attorney-client privilege as fundamental to the nature of all legal services, but this catch-all definition of the attorney-client privilege is not undisputed in the United States. "Once a lawyer goes beyond giving legal advice," says Jack Blum, "and starts setting up a bank account or incorporates a company for their client, then the attorney-client privilege does not apply."[152]

Internationally, a catch-all definition of attorney-client privilege is not widely shared. Unlike the United States, the European Union extends different degrees of attorney-client privilege to defense lawyers, on the one hand, and lawyers who engage in

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[148] "Task Force on Gatekeeper Regulation and the Profession," *American Bar Association*, https://www.americanbar.org/groups/criminal_justice/gatekeeper.html.

[149] "Frequently Asked Questions About the Gatekeeper Initiative and the Voluntary Good Practices Guidance," *American Bar Association*, https://www.americanbar.org/content/dam/aba/publications/criminaljustice/gatekeeper_faq.authcheckdam.pdf.

[150] "NAR Issue Summary Business / Money Laundering and Terrorist Financing," *National Association of Realtors*, http://narfocus.com/billdatabase/clientfiles/172/issue_pdfs/61.pdf.

[151] "State Incorporation - Collection of Company Ownership Info," *National Association of Secretaries of State*, http://www.nass.org/index.php/initiatives/state-incorporation-collection-company-ownership-info.

[152] Jack Blum in discussion with the authors, May 2, 2017.

transactional work, on the other.[153] "There is certainly precedent for countries applying AML regulations to transactional lawyers even when they recognize attorney-client privilege," says Heather Lowe.[154]

The findings of the Geographic Targeting Order pilot scheme have also lent credibility to the suggestion that high-end real estate is a major money laundering risk.[155] With more evidence from the Department of Treasury and increased pressure to address this key vulnerability, real estate professionals may be required to participate in AML efforts in the future. Additionally, interviews with state secretaries have revealed a more nuanced opinion of beneficial ownership legislation. "I'm open to reform," says Jeffrey Bullock, Delaware's Secretary of State, "if it's done right at the federal level and applies equally to all states".[156]

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[153] "Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing," *EUR-Lex*, May 20, 2015, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32015L0849.
[154] Heather Lowe in discussion with the authors, May 26, 2017.
[155] "Advisory to Financial Institutions and Real Estate Firms and Professionals," *Financial Crimes Enforcement Network*, August 22, 2017, https://www.fincen.gov/sites/default/files/advisory/2017-08-22/Risk%20in%20Real%20Estate%20Advisory_FINAL%20508%20Tuesday%20%28002%29.pdf.
[156] Jeffrey Bullock in discussion with the authors, May 15, 2017.

Conclusion: What Must Be Done

TThe United States must be proactive, not reactive in its efforts to combat illicit finance from kleptocracies. This requires addressing the weaknesses of SARs and PEP controls; mandating gatekeeper professions to cooperate with anti-money laundering efforts; passing beneficial ownership legislation; closing down the loopholes that allow for the placement, layering, and integration of illicit funds; and strengthening the enforcement of anti-money laundering statutes. Until there is political will to change the U.S. AML system from one that focuses on the detection of illicit funds to one that emphasizes the *prevention* of illicit funds from entering the system, the U.S. financial system will remain open to abuse by kleptocrats and their enablers.

The failure of the U.S. AML system and the rise of the kleptocrats' enablers will require a sustained campaign in Congress to redress. While the flaws in the U.S. AML system and self-regulation are plainly apparent to experts and readers of this report, there is a chronic lack of general awareness about the issue and how it connects to national security. However, the recent bipartisan push by leading U.S. senators and members of the House to introduce bills restricting the creation of anonymous shell companies and limiting other AML loopholes provides the political momentum for further reform. In order to win over and educate members of Congress, the senators and representatives involved should set up a bipartisan Joint Special Committee on Kleptocracy to assess the policy breakdown outlined in this report and propose recommendations. In parallel, a Kleptocracy Study Group should be established to work with U.S. allies and share best practices.

The aim of both the Joint Special Committee and the Study Group should be threefold: first, to find ways that existing U.S. legislation can be expanded so the legal, incorporation, and real estate sectors are given AML responsibilities; second, to examine the common methods used by kleptocrats and hostile regimes to launder their money and promote coordinated action among federal and state agencies to address key vulnerabilities; and, finally, the Joint Special Committee and the Study Group should strive to identify ways in which the existing AML structure must be both strengthened and updated in light of new technologies and globalization. The reports and policy conclusions of both the Joint Special Committee and the Study Group should be coordinated in order to maximize the effectiveness and appeal of necessary legislative reforms in the future.

Will this be enough? We believe that the creation of a Joint Special Committee and a Study Group first—rather than immediate pursuit of stand-alone legislation—is the best path forward for reform. This way, a sustained educational effort can take place on the Hill and tie together the work of anti-corruption campaigners and federal investigators into lasting and meaningful overhaul of the AML system to end Western enablement of kleptocracy.

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