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AML/CFT - Phase 2 extension

About the author: Formerly a lawyer of 25 years, I have nearly completed a 3-year PhD research program with Professor Jason Sharman of Griffith University, designed to fill a knowledge gap in the role of professional facilitators such as lawyers, accountants and real estate agents enabling financial transactions involving proceeds of crime. Delving deeper than cases in which professional facilitators have been prosecuted, the research has isolated and assessed every relevant incidence within specified parameters in which facilitators enabled transactions involving criminal proceeds. It places this new evidence and existing literature on the money laundering vulnerabilities of professional facilitators within an overarching policy effectiveness framework. Analysis and assessment was based not against simplistic and arguably futile measures such as whether rules are in place, or whether they match FATF recommendations, but whether they actually work, in terms of achieving underlying policy objectives. The thesis also assesses and extends existing measures for assessing the effectiveness of international and national anti-money laundering policies, and uses the evidence base to develop practical new assessment tools and methodologies to better support the conversion of professional facilitators unwittingly enabling financial transactions with criminal proceeds into more effective sentinels.

Overview

1. Implemented as proposed, the phase 2 extension of AML/CFT obligations will likely:

    a) achieve the objective of appearing to bring New Zealand into line with international standards; and

    b) make a positive but not significant difference in terms of materially and substantially improving New Zealand's capacity to detect, prosecute and prevent serious crime.

2. By co-mingling alternative policy objectives, the proposals appear to advance a simplistic policy framework that, from an over-arching crime prevention, anti-money laundering and counter-terrorist financing perspective, risks achieving an underwhelming policy outcome.

3. This submission invites policymakers to make an express choice of primary policy objective, and to direct implementation and evaluation with policy effectiveness its touchstone. The successful implementation of a new effectiveness framework designed expressly to materially and substantially advance the capacity to detect, prosecute and prevent serious crime presents New Zealand with the opportunity demonstrably to improve social and economic outcomes, and a unique leadership opportunity on the global stage.

"The real issue… is the extent to which it will be more rules, or rules that have some real prospect of actually working as intended. If the latter, and we materially step up the capacity to prevent significantly more societal and economic harm, it might be worth it. If the former, ie an exercise in international 'optics' with costs imposed mostly on the private sector, not so much." Ron Pol

Comments on Key wary of foreign buyer taxes and AML move, Bernard Hickey, Interest, 12 Sept 2016

Will the real policy objective please step forward?

4. The fundamental question is simple. What is the primary policy objective of the proposed AML/CFT extension to phase 2 professions? Is it:

   A. To meet New Zealand's international obligations?
   As expressed by Justice Giles: "The money laundering offence was introduced into our law in 1995 in order that New Zealand discharge its international obligations under the United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances 1988, commonly known as the Vienna Convention" (R v Wallace, 1988, p3)

   B. To (materially and substantially) improve New Zealand's capacity to detect, prosecute and prevent serious crime?
   As expressed by Justice Heath: "The objective of the requirement to report suspicious transactions is to ensure that authorities are alerted to potential criminal activity at an early stage so that investigative procedures can be invoked promptly. The underlying philosophy is to ensure early detection by placing the obligation to report on respectable citizens (both corporate and individuals)" (R v Devereux, 2002, para 48).

5. The proposals sometimes suggest the latter, albeit absent parenthetical descriptors of degree. Its title optimistically proclaims intent to "Improv[e] New Zealand's ability to tackle money laundering and terrorist financing". Repeatedly throughout, however, it evidences the former.

6. Briefing papers share an apparent lack of goal clarity. For example, in documents obtained under the Official Information Act by the NZ Herald (Police and officials warn of property laundering, Matt Nippert, 10 Sept 2016), it was recorded in June 2015 that "New Zealand's AML/CFT work… is driven by our international obligations under the [FATF] Recommendations", even as officials noted that "leaving gaps in coverage potentially provides a 'road-map' for would-be money launderers". Likewise, in April 2016, timing options for progressing phase 2 were influenced by four factors. The first of these related to the 2017 election and meeting New Zealand's international obligations before the next FATF mutual evaluation. Trailing in fourth place was "the need to close the gaps in NZ's AML/CFT regime,.. to prevent misuse… by criminal interests".

7. It is therefore unremarkable that the proposals exhibit a similar lack of goal clarity. It would be a relatively simple task to list examples, but would serve little purpose beyond an academic exercise in destructive futility. A more constructive path is suggested by repeated assertion of the proposals being based on "identified risks and international standards". Each component of this phrase offer more positive and constructive scope for policy development insight, as outlined briefly in the following two subsections. The next subsection then outlines why policy objective clarity matters, and a penultimate section before the concluding comments suggests that a more purposive policy objective may be better and cheaper.

Narrow focus on "identified risks" inherently limiting

8. It is said that a benefit of extending the AML/CFT regime to professional facilitators will "help stop the 'displacement effect' where criminals move their funds … outside of regulated sectors in a bid to avoid detection". Yet there is "no intention to include all services provided by these sectors", and AML/CFT obligations will be "limited to activities that criminals are known to exploit." It is, however, axiomatic of the displacement effect that activities criminals are known to exploit will shift; ironically, as evidenced by the very reasons advanced to extend AML/CFT to the professions - to reduce the displacement effect caused by their exclusion.

9. Likewise, the obvious "substitution pressure" when the "sanctioned loophole" of the professions' exemption was itself widened in last minute amendments to AML/CFT created

the very displacement effect that was, even then, its self-evident consequence (eg New obligations affect lawyers, *LawTalk*, 21 June 2013).

10. A feature of the displacement effect is that it is equally self-evident that policy initiatives constrained by "known" exploits will themselves create their own displacement effect. Proposals based on "identified risks" implicitly fail to address actual risks in the targeted industries, which by nearly any measure of laundering activity and interdiction rates is clearly more expansive, as evidenced by the existing literature, the experience of other countries, and detailed research specifically in this area. It is reinforced also by a sampling exercise conducted by NZ Police which reported that "professional services and the real estate sector are closely linked to organised crime and drug offending", and in most such cases "offenders were ultimately successful in integrating criminal proceeds by purchasing real estate" (Source: Documents obtained under Official Information Act by NZ Herald).

11. Moreover, if the discourse on "identified risks" is largely constrained by the few cases in which facilitators have been prosecuted or a wider sampling of cases, it will inevitably fail to address the *actual* risks which, by application of methodical rigour and more in-depth research and analysis, are *capable* of being identified, and thereby more effectively countered.

12. These observations are, however, relevant only if the primary policy objective is materially and substantially to improve the capacity to detect and deter serious crime. If the primary policy goal is simply to meet international standards, addressing the easily "identified" risks may well be sufficient, without much need for evidential rigour; evidence-based policymaking has little relevance in the face of mechanistic application of the "received wisdom" of international standards. (Nor is this critical of officials. To the contrary. Their commitment shines through the policy documents, and it remains a reasonably common view that FATF standards represent 'the' solution, which itself may inadvertently cloud constructive analysis drawing more extensively from the emerging policy effectiveness discourse in anti-money laundering scholarship, evidence and practice).

"International standards" may be necessary, but not sufficient

13. The latter part of the oft-repeated phrase, of policies based on "international standards", appears implicitly to assume that those standards are sufficient to meet AML/CFT risks. This assumption, which as noted above remains relatively widely held, inadvertently disregards a growing body of evidence and experience indicating otherwise.

14. Again, if the primary policy goal is to meet international standards, uncritical and unimaginative application of FATF recommendations may well be sufficient, but from the perspective of serious crime prevention as a central policy goal, it is for the reasons expressed above unremarkable yet disquieting that the proposals frequently posit the extent of the phase 2 extension of AML/CFT obligations as reflective of the basic form of FATF recommendations, seemingly absent reflection on their substance, intent and direction.

15. Meeting New Zealand's international obligations is of course a legitimate aim, asserted by what the proposals claim a "primary aim" of the legislation. The Act's first policy objective, however, is "to detect and deter money laundering and the financing of terrorism". These objectives are not, of course, mutually exclusive. Meeting one may help meet another. And where there is any trade-off, the choice is of course with policymakers. I suggest, however, that any such choice should at least be explicit. Otherwise, the proposals' co-mingling of policy objectives seemingly illustrates an underlying assumption that "bring[ing] New Zealand into line with international AML/CFT standards" creates a perception that it has become the de-facto primary policy objective, or is sufficient to meet *all* policy objectives.

16. If the lead policy goal is to bring New Zealand into line with international standards, the proposal outlines a framework for doing so, notwithstanding a few gaps and a likely need for subsequent revision to meet a changing evidence-base already evident. It may also be expected to have some positive crime detection and prevention effects.

17. AML/CFT is more expansive than FTRA, and will no doubt be welcome by enforcement agencies because it should make some difference in terms of crime detection and prevention capabilities, but a growing body of evidence, experience and practice advocates that an adherence to the form of rules that "bring New Zealand into line with international AML/CFT standards" without full cognisance of their substance, intent and direction may not materially advance, and at considerable expense to industry may only marginally advance, the Act's first policy objective, to "detect and deter money laundering and the financing of terrorism".

Policy objective clarity matters

18. The legislative framers responsible for expressing Parliament's policy intentions did so, in my opinion, with a remarkable precision in order of significance:

> The purposes of this Act are—
> (a) to detect and deter money laundering and the financing of terrorism; and
> (b) to maintain and enhance New Zealand's international reputation by adopting, where appropriate in the New Zealand context, recommendations issued by [FATF]; and
> (c) to contribute to public confidence in the financial system.

19. Based on the evidence of anti-money laundering risks actually experienced by facilitators, meeting policy objective (b) may contribute to (c), at least in the short-term, but may not materially or substantially advance (a), and may in time ultimately detract from (c). Meeting policy goal (a), however, leads to the trifecta presumably intended by policymakers.

Higher order objectives may be less costly, not more

20. For clarity in these submissions in an area that might otherwise be lacking, I do not suggest that AML/CFT extension to phase 2 professions is not useful or necessary, or that the FATF recommendations are meaningless. I concur with officials' repeated assessments that the proposed extension is an important component of New Zealand's anti-money laundering regime, and that the FATF recommendations are an invaluable resource in that regard. The literature and evidence suggests that both may well be *necessary*, but they are increasingly recognised as not *sufficient* to meet an underlying policy objective of materially and substantially improving the capacity to detect and deter serious crime.

21. Nor does the New Zealand research suggest that obligations *more* onerous than the FATF requirements are necessary to meet the underlying ultimate policy objective. Paradoxically, the opposite may be true. Preliminary results indicate that it may be possible to meet the primary crime detection and prevention policy objective with *no more*, and quite possibly a *less* onerous and less costly compliance burden than simple policy initiatives designed to "bring New Zealand into line with international AML/CFT standards."

> "It's not enough that we put the usual rules in place. The real question is whether they actually work and what will make them more effective in helping to detect, prosecute and prevent serious crime," Pol said. "The full suite of rules over the UK professions hasn't worked as well as expected. New Zealand and Australia have an opportunity to do something different that might actually meet the policy objectives."
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> In NZ leaps ahead of Australia with next phase of AML/CFT reforms, Nathan Lynch, 12 Sept 2016, with permission, first published in Thomson Reuters' Regulatory Intelligence.

Conclusion

22. The current proposal appears to promote the Act's second policy objective over its first, or inadvertently co-mingles policy goals. This submission invites policymakers to make an express choice of primary policy objective.

23. This suggestion is not directed at enforcement agencies. They will no doubt target any incremental gains available. Nor for policy officials. Their expertise lies in crafting proposals designed to meet objectives directed by policymakers, and they appear admirably to have crafted a framework for bringing New Zealand into line with at least the form and appearance of international standards. Achieving a higher-order policy objective, however, such as to materially, substantially and demonstrably improve New Zealand's capacity to detect, prosecute and prevent serious crime, requires the political will, and direction, to do so.

24. Moreover, other countries, and FATF, continue to struggle to achieve meaningful results with a global policy shift towards what is termed an 'effectiveness' outcomes framework. New Zealand's successful implementation of a new effectiveness framework that successfully and substantially advances the capacity to detect, prosecute and prevent serious crime presents an opportunity demonstrably to improve social and economic outcomes for New Zealand, and a unique leadership opportunity on the global stage.

Sincerely,

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