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Practical cross-border insights into anti-money laundering law

Anti-Money Laundering 2023

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Industry Chapter

1 **Hot Topics in AML and Financial Crimes for Broker-Dealers**
Bernard Canepa, SIFMA

Expert Analysis Chapters

6 **Key BSA/AML Compliance Trends in the Securities Industry**
Stephanie L. Brooker & Chris Jones, Gibson, Dunn & Crutcher LLP
Bernard Canepa, SIFMA

16 **A Primer on Navigating Source of Wealth Issues**
Jonah Anderson & Joel M. Cohen, White & Case LLP

21 **Anti-Money Laundering and Cryptocurrency: Legislative Reform and Enforcement**
Kevin Roberts, Alix Prentice, Duncan Grieve & Charlotte Glaser, Cadwalader, Wickersham & Taft LLP

28 **Money Laundering Risk and AML Programmes for Non-Regulated Sectors**
Brian T. Markley, Brock B. Bosson & Jennifer W. Potts, Cahill Gordon & Reindel LLP

32 **Evolution of Financial Services and Art: AML Practitioners – Ignore Progress at Your Peril**
Stella M. Mendes & Michael Buffardi, FTI Consulting

39 **The Convergence of AML Programmes for Non-Regulated Sectors, Trade-Based Money Laundering, and Data-Driven Technical Solutions**
Jamal El-Hindi, David D. DiBari, Gerson Raiser & Dorothée Vermeiren, Clifford Chance

48 **Compliance Issues Facing Financial Institutions When Accessing FinCEN's Beneficial Ownership Database Under the CTA**
Matthew Biben, Shas Das & Jeff Telep, King & Spalding

53 **Anti-Money Laundering in the Asia-Pacific Region: An Overview of the International Law Enforcement and Regulatory Frameworks**
Dennis Miralis & Phillip Gibson, Nyman Gibson Miralis

67 **AML and CFT Compliance in South Korea for Financial Institutions, Cryptocurrencies and NFTs**
Hyun-il Hwang & Jaecheong Oh, Shin & Kim LLC

Q&A Chapters

72 **Australia**
King & Wood Mallesons: Kate Jackson-Maynes & Sam Farrell

81 **Brazil**
Joyce Roysen Advogados: Joyce Roysen & Veridiana Vianna

89 **China**
King & Wood Mallesons: Stanley Zhou & Yu Leimin

97 **Colombia**
Fabio Humar Abogados: Fabio Humar

104 **France**
Bonifassi Avocats: Stéphane Bonifassi & Sinem Paksut

112 **Germany**
Herbert Smith Freehills LLP: Dr. Dirk Seiler & Dr. Daisy Hullmeine

120 **Greece**
Anagnostopoulos: Ilias Anagnostopoulos & Alexandros Tsagkalidis

128 **Hong Kong**
K&L Gates: Sacha Cheong & Christopher Tung

136 **India**
Cyril Amarchand Mangaldas: Cyril Shroff, Faraz Sagar, Sara Sundaram & Pragati Sharma

150 **Ireland**
Matheson: Joe Beashel & Ian O'Mara

157 **Isle of Man**
DQ Advocates Limited: Chris Jennings & Sinead O'Connor

164 **Liechtenstein**
Marxer & Partner Attorneys at Law: Laura Negele-Vogt, Dr. Stefan Wenaweser, Dr. Sascha Brunner & Katharina Hasler

173 **Malaysia**
Skrine: Lim Koon Huan, Manshan Singh & Elizabeth Goh

183 **Malta**
Ganado Advocates: Mario Zerafa, Luigi Farrugia & Bettina Gatt

191 **Mozambique**
MDR Advogados: Mara Rupia Lopes & Duarte Santana Lopes

Q&A Chapters Continued

198 **Nigeria**
Threshing Fields Law: Frederick Festus Ntido

205 **Portugal**
Morais Leitão, Galvão Teles, Soares da Silva & Associados: Tiago Geraldo & Teresa Sousa Nunes

215 **Romania**
Enache Pirtea & Associates: Simona Pirtea & Mădălin Enache

223 **Singapore**
Drew & Napier LLC: Gary Low & Terence Tan

233 **Switzerland**
Kellerhals Carrard: Dr. Florian Baumann & Lea Ruckstuhl

243 **Taiwan**
Lee and Li, Attorneys-at-Law: Robin Chang & Eddie Hsiung

251 **United Kingdom**
White & Case LLP: Jonah Anderson

261 **USA**
Gibson, Dunn & Crutcher LLP: M. Kendall Day, Linda Noonan & Ella Alves Capone

Money Laundering Risk and AML Programmes for Non-Regulated Sectors

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Introduction

What are the anti-money laundering ("AML") obligations of non-financial institutions, and what kind of AML-related risks do these companies actually face? Such questions come up often because, while many are well aware of the risks and requirements imposed on banks, credit unions, broker-dealers and other traditional financial institutions, most have not thought much about AML risks facing the rest of the business world, and may have no idea how (or even if) AML requirements apply in non-financial sectors.

In fact, while the strict AML requirements of the U.S. Bank Secrecy Act ("BSA") apply only to certain enumerated types of financial institutions – defined at 31 U.S.C. § 5312 – there are two separate laws (18 U.S.C. §§ 1956 and 1957) that apply to *all* U.S. persons and entities, and broadly prohibit, among other things, knowingly engaging in a transaction involving criminally derived property. Specifically, 18 U.S.C. § 1956 makes it illegal to conduct or attempt to conduct a financial transaction with proceeds known to arise out of illegal activity. This statute applies where a transaction is intended to promote specified unlawful activity, conceal the nature and source of funds, or to avoid reporting requirements. Likewise, 18 U.S.C. § 1957 prohibits conducting a monetary transaction in an amount greater than $10,000 with property known to be derived from criminal activity. Neither statute requires actual knowledge, as wilful blindness is enough to trigger liability. In addition to potential criminal sentences, fines and penalties, U.S. authorities may also seek civil forfeiture of criminally derived property. Thereby, for example, if an individual or company buys an apartment, automobile, or other high-value asset that was originally acquired by the seller with the proceeds of a crime, the government may obtain a court order that effectively confiscates the asset from the buyer. Importantly, any individual or company may challenge such a civil forfeiture based on an "innocent owner" defence, requiring proof that the person or company was a *bona fide* purchaser for value and lacked knowledge of the alleged criminal activity. This is one of many reasons why all companies (not just financial institutions) are well served by having in place robust policies, procedures and controls to detect and prevent money laundering activity.[1]

With this in mind, we present below a brief discussion of some of the particular AML-related risks facing non-financial institutions, with a focus on three specific sectors (retail, real estate and private equity), and also offer some specific best practices to mitigate potential risk.

The Retail Sector

The types of money laundering activity affecting the retail sector are varied, but often include some form of trade-based money laundering, where both parties to a transaction participate (often through rogue employees) in the underlying misconduct. These are among the most common and difficult-to-detect schemes and often involve the use of everyday transactions to disguise the proceeds of a crime, typically through misrepresentations of the price, quantity or quality of goods. These schemes have increasingly occurred in e-commerce settings where, for example, a vendor might establish a website that appears to offer legitimate items as a way to mask criminal activities, such as drug dealing or illegal arms sales, thus allowing payments to pass through online systems undetected. Vendors may even ship empty boxes to "buyers" as "evidence" that a real transaction occurred. Companies that allow peer-to-peer sales on their e-commerce sites should be mindful of such schemes, regardless of whether they are considered a money services business subject to the full scope of the BSA.

Bad actors in the retail sector may also seek to use online marketplaces as a way to resell stolen goods. Indeed, organised retail crime has been on the rise in recent years, in part due to the ease with which stolen goods can be sold online anonymously by third-party sellers through online giants like Amazon, eBay and Facebook Marketplace. Though these companies have reportedly taken actions to crack down on illegal sales, such as through enhanced seller verification, the industry remains a target for bad actors. In May 2022, law enforcement authorities in New York charged 41 people in connection with an organised crime ring that stole thousands of products, including over-the-counter medication, other drug store items, and luxury clothing and goods, then resold them on eBay. The proceeds from these sales were laundered through PayPal and bank accounts in order to conceal their true origin. Authorities seized more than $3.8 million's worth of stolen items, more than 550 stolen gift cards, and more than $300,000 in cash from the alleged boss of the enterprise.

Retailers should be careful even when dealing with counterparties that obviously operate legitimate businesses, as those businesses may still be used in part to help conceal the proceeds of illicit activities. For example, a retailer may have supplier relationships with entities connected to illegal activity, such as ultimate beneficial owners who are subject to U.S. trade sanctions or other

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restrictions. Suppliers based in jurisdictions with a heightened risk of money laundering activity, particularly those operations with high overhead expenses such as agribusiness and manufacturing, present the highest risk of such activity, though it could occur in any industry, anywhere in the world, including the U.S. While a retailer may be able to avoid legal liability under AML statutes if it demonstrates a lack of knowledge that its supplier was using its legitimate business to facilitate money laundering, the retailer could still face liability under other statutes (*e.g.*, related to trade sanctions) that do not have knowledge requirements, as well as potential reputational harm.

The luxury retail market has been targeted specifically by money launderers as a way to park (or further disguise through reselling) their illicit gains in items that retain value, such as luxury watches or cars. While some segments of the luxury retail market fall within the BSA's definition of "financial institution", such as dealers of precious metals, stones or jewels, many other types of luxury retailers are not obligated to comply with BSA requirements. Regardless, retailers of all types should be mindful that they may be targeted by money launderers and, accordingly, maintain adequate risk-based compliance controls that are implemented and ingrained throughout their organisations.

The Real Estate Sector

Criminal actors may seek to use the purchase of real estate as a way to integrate illicit funds into the legal economy. While certain participants in the real estate sector are regulated under the BSA, including residential mortgage lenders and banks involved in real estate financings, others are not, even though there is significant risk to the sector as a whole. Among other things, buyers may present risk by seeking to obscure their identities through opaque legal entities or nominee purchasers and title holders. This risk is exacerbated in the commercial real estate market, which tends to involve less transparency by virtue of more complex payment and ownership structures. Buyers might also seek to engage in all-cash purchases that avoid the use of mortgage lenders and the accompanying higher level of AML scrutiny, including with respect to recordkeeping and reporting requirements. By contrast, real estate transactions that involve bank financings are generally less susceptible to money laundering, as banks must report suspicious activity, though it can still be difficult to identify the actual owner of a property behind various shell companies.

The luxury real estate market has historically been of particular interest to money launderers looking for ways to park embezzled funds in a sector that typically offers steady and stable growth. One example is in the high-profile scheme in which Malaysian businessman Jho Low allegedly conspired to embezzle more than $4.5 billion from Malaysia's sovereign wealth fund, 1Malaysia Development Berhad ("1MDB"), including by purchasing more than $150 million in luxury real estate in the U.S. through shell companies. Real estate agents, title insurance and escrow companies, and attorneys were allegedly involved in certain transactions of Low's transactions, without raising adequate concern about the source of his funds.

Russian kleptocrats have also long made use, through shell companies and middlemen, of the luxury real estate market in the U.S., the U.K., and other developed economies as a way to quietly invest money outside of Russia. Following Russia's invasion of Ukraine in early 2022, the U.S. and its allies imposed, and continue to impose, sweeping sanctions on many Russian officials, politically exposed persons, and other government-aligned elites. As part of its enforcement efforts, the U.S. Department of Justice ("DOJ") established Task Force KleptoCapture with the goal of identifying sanctions evasion and related criminal conduct, including money laundering, and using enforcement mechanisms such as asset seizures and civil forfeitures of unlawful proceeds, including personal real estate.[2] In the year since the task force was established, it has brought charges against at least 35 individuals and corporate entities and has seized, forfeited or otherwise restrained more than $500 million in Russian oligarch assets, including U.S. real estate. For instance, on February 24, 2023, the anniversary of Russia's invasion of Ukraine, the DOJ filed a civil forfeiture action against six luxury properties, claiming they were the proceeds of sanctions violations and international money laundering. The properties, located in New York and Florida, were valued at approximately $75 million. They were beneficially owned by Russian oligarch Viktor Vekselberg and had been acquired with the assistance of a New York attorney who had been retained by a close business associate of Vekselberg. After Vekselberg was sanctioned in 2018, the source of funds used to maintain and service the properties changed, but the funds for the upkeep of the properties continued to be managed through the New York attorney under direction from Vekselberg's close business associate, and attempts were made to sell some of the properties. No OFAC licenses were sought in connection with any of the continued payments to maintain the properties or the attempts to transfer the properties.[3]

In 2016, the Financial Action Task Force ("FATF") issued a report evaluating the U.S. regulatory framework for AML and counter-terrorist financing measures. One of the FATF's findings was that the U.S. had an insufficient regulatory regime to address the AML risks posed by the real estate sector, and that, among other things, the U.S. exemption of real estate agents from its AML requirements was not in line with FATF standards.[4] There have been some recent efforts to close these gaps, in particular by the Financial Crime Enforcement Network ("FinCEN"), the arm of the U.S. Treasury Department responsible for enforcing the BSA and combatting money laundering. In 2016, FinCEN began issuing Geographic Targeting Orders ("GTOs"),[5] which are temporary orders that require U.S. title insurance companies to identify beneficial owners behind shell companies used in all-cash purchases of residential real estate in specified jurisdictions and areas. The GTOs, most recently renewed in late October 2022 for an additional six months, cover certain counties within major U.S. metropolitan areas across 12 states and Washington, D.C. With one exception, the GTOs require disclosure of all-cash purchases above $300,000.[6] Thus far, these GTOs appear to have had an impact. According to one study, GTOs led to a 70 per cent reduction in corporate entities purchasing all-cash luxury real estate in 2016. A 2017 FinCEN study also found that more than 30 per cent of beneficial owners reported under GTOs were also the subject of Suspicious Activity Reports ("SARs"), which are documents that financial institutions must file with FinCEN whenever there is a suspected case of money laundering or fraud.

In December 2021, FinCEN further announced an Advance Notice of Proposed Rulemaking to solicit public comments on a potential rule that would impose broad recordkeeping and reporting requirements in certain all-cash transactions in the U.S. real estate market, and expand and continue certain reporting requirements in line with what has been required under GTOs.[7] FinCEN's request for public comment specifically concerned (i) the scope of any such regulations, including which purchasers and types of purchases should be covered, (ii) the information that should be reported and retained, and (iii) potential geographic limitations and reporting thresholds, along with other alternatives for how to address the risk of money laundering in all-cash transactions. Though the comment period closed in early February 2022, no final rule to date has been issued and any resulting regulations remain to be seen.

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Private Equity Sector

Typically, private equity funds do not fall within the definition of "financial institution" under the BSA, and are thus not required to maintain a formal AML compliance programme, submit SARs, or otherwise participate in information-sharing programmes under the PATRIOT Act. The sector is nevertheless exposed to AML risk in some of the same ways as traditional financial institutions, especially given its role in receiving and investing funds from private investors. This was highlighted in a leaked intelligence bulletin from the U.S. Federal Bureau of Investigation ("FBI") from May 2020, which warned that private equity funds were being used increasingly as a way for bad actors to launder money. While this is most likely to occur when funds are coming from bank accounts in countries with weak AML requirements and/or where beneficial ownership of investors may be masked, the risks identified by the FBI are broadly applicable.

The leaked FBI bulletin referenced several recent real-world examples of how private equity funds have been used to launder money. One involved the OneCoin cryptocurrency Ponzi scheme in which individuals laundered more than $400 million through a series of fictitious private equity funds through accounts in offshore jurisdictions. In another example, a New York-based private equity fund reportedly received more than $100 million in funds from a Russia-based company allegedly associated with organised crime.

In its December 2021 Strategy on Countering Corruption, the Biden administration stated that the Treasury Department will revisit a 2015 Notice of Proposed Rule Making that sought to impose AML requirements for certain investment advisors and consider whether to extend the existing AML regime to private placement funds.[8]

Compliance Controls for Non-Financial Institutions

Being aware of how a business could be targeted or otherwise impacted by money laundering is the first step in determining how to incorporate AML compliance into a broader compliance programme. This may include:

- Conducting robust due diligence on counterparties, including screening against sanctions and other watch lists to ensure the business is not dealing with a prohibited person, or someone otherwise connected to criminal activity. When red flags are identified, or a counterparty is otherwise deemed to present a heightened risk because of its location, the nature of its operations or other factors, companies should have a consistent, repeatable process for engaging in enhanced due diligence.
  - In the retail sector, this might mean conducting due diligence on customers and vendors.
  - In the real estate sector, it is often appropriate and necessary to conduct due diligence on buyers and to confirm the ultimate beneficial owners for any shell company buyers.
  - Private equity funds should likewise conduct due diligence on fund investors, including an analysis of beneficial ownership and broader due diligence in connection with investments and divestments. Based on the risk profile of an investor, a more robust AML due diligence process in line with requirements for BSA-covered financial institutions may be appropriate.
- Conducting AML-specific training and providing periodic AML-related communications to employees that focus on identifying red flags and other potential risk areas.
  - In the retail sector, this might include training for employees who handle high-volume cash transactions or gift card sales on how to spot suspicious transactions. Retail inventory buyers may also receive specialised training on spotting vendors that present heightened AML risk and suspicious activity.
  - For both the real estate and private equity sectors, employees should understand the concept of beneficial ownership and when additional ownership information should be sought from counterparties.
- Incorporating money laundering risks into a business's audit and risk assessment process, focusing on the identity and nature of typical counterparties, industry risks and business locations.

While these controls are by no means a guaranteed way of preventing money laundering, especially if intentionally circumvented by a rogue employee or other bad actor, having a robust AML compliance programme can help ensure that a company has adequate visibility into potential AML-related issues to help mitigate both potential risks and legal and reputational consequences across sectors.

Endnotes

1. In addition to these potential legal consequences, all companies face potential reputational exposure (as well as extensive investigation and remediation costs) if caught up in a money laundering scandal, even where they lack any knowledge of the relevant misconduct.
2. *Attorney General Merrick B. Garland Announces Launch of Task Force KleptoCapture*, The U.S. Department of Justice (Mar. 2, 2022), https://www.justice.gov/opa/pr/attorney-general-merrick-b-garland-announces-launch-task-force-kleptocapture.
3. *Civil Forfeiture Complaint Filed Against Six Luxury Real Estate Properties Involved in Sanctions Evasion and Money Laundering*, The U.S. Department of Justice (Feb. 24, 2023), https://www.justice.gov/usao-sdny/pr/civil-forfeiture-complaint-filed-against-six-luxury-real-estate-properties-involved.
4. *Anti-Money Laundering and Counter-Terrorist Financing Measures [in the] United States—2016*, Mutual Evaluation Report, Financial Action Task Force, pp 41–42, 120, 220–22, 233–35 (Dec. 2016), *available at* https://www.fatf-gafi.org/media/fatf/documents/reports/mer4/MER-United-States-2016.pdf.
5. *See FinCEN Takes Aim at Real Estate Secrecy in Manhattan and Miami*, FinCEN (Jan. 13, 2016), *available at* https://www.fincen.gov/news/news-releases/fincen-takes-aim-real-estate-secrecy-manhattan-and-miami.
6. *See FinCEN Renews and Expands Real Estate Geographic Targeting Orders*, FinCEN (Oct. 26, 2022), *available at* https://www.fincen.gov/news/news-releases/fincen-renews-and-expands-real-estate-geographic-targeting-orders-0. The pur chase amount reporting threshold is $300,000 for each of the covered metropolitan areas with the exception of the City and County of Baltimore, which has a purchase threshold of $50,000.
7. Anti-Money Laundering Regulations for Real Estate Transactions 86 Fed. Reg. 69589 (proposed Dec. 8, 2021) (to be codified at 31 C.F.R. Chapter X), *available at* https://www.govinfo.gov/content/pkg/FR-2021-12-08/pdf/2021-26549.pdf.
8. *See United States Strategy on Countering Corruption*, The White House, p. 22 (Dec. 2021), *available at* https://www.whitehouse.gov/wp-content/uploads/2021/12/United-States-Strategy-on-Countering-Corruption.pdf.

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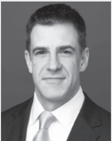

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