FINANCIAL CRIME BRIEFING

Financial crime compliance: joining up the dots

Recent regulatory actions against financial institutions in relation to anti-money laundering (AML) and sanctions compliance have heightened the focus on financial institutions to prevent themselves being used to facilitate financial crime. But in addition to regulatory risk, financial institutions are highly exposed to litigation risk where criminals and fraudsters use them to launder the proceeds of their wrongdoing.

Rather than chase elusive or impecunious defendants to recover misappropriated funds, fraud victims may seek recompense from the financial institution through which the proceeds of the fraud were paid.

Crédit Agricole Corporation and Investment Bank v Papadimitriou underscores the need for constant and careful diligence to mitigate these risks (*[2015] UKPC 13*). The Privy Council considered whether the victim of a fraud had a proprietary claim against Crédit Agricole, through which the proceeds of the fraud had been laundered (*see box "The dispute in Credit Agricole"*). It held that the bank had failed to make proper inquiries into the commercial purpose of the transaction and, had it done so, it would have been obvious that the transaction was probably improper. This was enough to make Crédit Agricole liable to the victims, and allow the victims to recover almost $10 million from the bank.

The dispute in *Crédit Agricole*

Following the death of her husband, Irene Michailidis owned a collection of art deco furniture. Their son, Christo Michailidis, had played a part in building up the collection. Following Christo's death in July 1999, the collection was sold by his partner, Robin Symes, for $15 million.

The Michailidis family found out about the sale in early 2001 and brought claims against Mr Symes, asserting that he had no right to sell the collection. The family discovered that $10.3 million of the sale price had been paid into an account at Crédit Agricole in Gibraltar, through a Panamanian company and a Liechtenstein foundation. The account was in the name of a British Virgin Islands company that had been incorporated at Mr Symes' request.

The transactions were part of a fraudulent scheme devised by Mr Symes and the funds were ultimately disbursed for his benefit. The family sued Crédit Agricole for dishonest assistance and knowing receipt and also brought a proprietary claim for the proceeds of the sale.

AML legal framework

The fraud at issue in *Crédit Agricole* took place in 2000 and 2001. Since then, AML regulations, and the sophistication with which financial institutions protect themselves, have developed significantly. The steps that financial institutions take to comply with the relevant regulations are closely entwined with the ways in which they can avoid becoming liable to the victims of fraud.

In the UK, AML obligations are dispersed across a number of sources, including the Money Laundering Regulations 2007 (*SI 2007/2157*), which implement the Third Money Laundering Directive (*2005/60/EC*), the Proceeds of Crime Act 2002 and the Terrorism Act 2000 (*see also News brief "Fourth Anti-Money Laundering Directive: preparing for launch", www.practicallaw.com/8-616-6194*).

Financial Conduct Authority (FCA) rules also require regulated firms to have adequate systems and controls in place to address money laundering risks. Part of the FCA's integrity objective includes ensuring that the UK financial system is not used for a purpose connected with financial crime (*section 1D(2)(b), Financial Services and Markets Act 2000*).

The FCA has clear expectations: firms in the financial sector must take reasonable care to establish and maintain systems and controls that are appropriate to their businesses (*FCA Handbook, Senior Management Arrangements, Systems and Controls (SYSC) 3.1.1*). This includes ensuring that systems and controls enable the firm to identify, assess, monitor and manage money laundering risks (*SYSC 3.2.6A(1)*).

The Joint Money Laundering Steering Group (JMLSG) issues detailed guidance and interpretation for the financial sector on the legal and regulatory framework (*www.jmlsg.org.uk/*). The JMLSG guidance is intended to help firms in the financial sector to manage money laundering risks in a thoughtful and considered way, and to comply with regulatory expectations.

A cornerstone of managing money laundering risk is a firm's customer due diligence procedures, which typically involve identifying the customer, verifying the customer's identity, identifying any beneficial owner and verifying their identity, and obtaining information on the purpose and intended nature of the business relationship with the customer (*paragraph 5.15, JMLSG guidance*).

Another central component is the ongoing monitoring of transactions and activities to identify and report any suspicious activity. This is intended to ensure that transactions conducted through the financial institution are consistent with its knowledge of the customer. The JMLSG guidance explains that unusual activities, which cannot be rationally explained, may involve money laundering or terrorist financing (*paragraph 5.7.2, JMLSG guidance*).

Commercial purpose of the transaction

In *Crédit Agricole*, the claimants argued that the bank had not undertaken adequate checks to establish where the funds had come from. However, the first instance judge in Gibraltar did not think that further inquiries about the source of funds paid through Crédit Agricole would have put the bank on notice of the wrongdoing. Although the bank would have seen that the funds had come from an account elsewhere, this

Dishonest assistance

Where a third party dishonestly assists a trustee to commit a breach of trust, the third party will be liable to the beneficiary of the trust for the losses caused by the trustee's breach. It is not necessary for the third party to receive trust property. The concept of honesty is an objective concept, and a person acts honestly if he attains the standard that an honest person in the same situation would attain. According to the House of Lords in *Royal Brunei Airlines v Tan*, in most cases, an honest person should have little difficulty in knowing whether a proposed transaction, or his participation in it, would offend the normally accepted standards of moral conduct (*[1995] 2 AC 378; www.practicallaw.com/6-100-3325*).

would not have put it on notice that the funds derived from a fraud.

However, the Privy Council found that such narrow and specific inquiries would not have been sufficient. The focus of Crédit Agricole's inquiry should not have been confined to the source of the funds but should have extended, in particular, to the commercial purpose of the transaction.

This broader approach required the bank to probe for satisfactory explanations of features of the transaction that may have indicated wrongdoing before it could be assumed that there was no wrongdoing. This included the fact that the funds had passed through entities in Panama and Liechtenstein. The Privy Council explained that, on the facts known to Crédit Agricole, there was no apparent explanation of why the Panamanian and Liechtenstein entities had been used, unless it was to conceal the origin of the funds. So the bank should have made inquiries before proceeding as if there was an innocent explanation.

By failing to make adequate inquiries, Crédit Agricole could not be said to have received the funds as a good faith purchaser for value. Although it did not know that the funds were the proceeds of a fraud, it had constructive notice of the victims' rights and should have made inquiries to establish the position. The Privy Council emphasised that a bank must make inquiries if there is a serious possibility of a third party having a right to the funds or if the facts known to the bank would give a reasonable banker in the position of the particular banker serious cause to question the propriety of the transaction.

Although, by the time it reached the Privy Council, the case focused only on proprietary claims, there are other claims that may be open to the victim of a fraud against those involved in dispersing the proceeds of the fraud; in particular, claims for dishonest assistance and knowing receipt (*see boxes "Dishonest assistance" and "Knowing receipt"*).

Practical steps to mitigate risk

In practice, many financial institutions have significantly developed their AML capabilities in recent years. However, where there are warning signs about a particular transaction, a financial institution should make adequate inquiries to resolve any uncertainties and should, where appropriate, look at the commercial rationale for the transaction or its structure.

The warning signs will be different in every case, and the particular facts known to the institution are critical to determining whether further inquiries are called for. However, the following questions are a starting point to consider whether further investigation is needed:

- What is the commercial purpose of the transaction, and how does the proposed structure achieve it?
- Does the transaction involve the use of intermediate entities without any apparent purpose, particularly where an intermediate entity is located in a jurisdiction with strict bank secrecy rules?
- Are there elements of the transaction structure that may disguise the origin of the funds?

Knowing receipt

A third party will be liable to a beneficiary where it receives or deals with trust property, knowing that the property has been received or is held in breach of trust, which can include property held on a constructive trust that may arise where assets have been obtained by fraud. Liability is therefore receipt-based and does not depend on showing that the third party acted dishonestly (*Twinsectra v Yardley [2002] UKHL 12; www.practicallaw.com/6-101-7153*).

- Is the transaction out of the ordinary for the customer?
- Is the customer dealing with sums of money beyond what might be expected, based on what the institution knows about its situation and the source of its wealth?
- Does the customer present a high money laundering or financial crime risk for other reasons, for example, if he is a politically exposed person?

Further investigation should not follow a "box-ticking" approach; inquiries should be aimed at addressing and resolving the questions raised by the information available to the financial institution. If unsatisfactory responses are received, or open further questions, additional inquiries should be made until it is clear that the transaction is legitimate or, indeed, that it is not, in which case reporting obligations will be need to be considered.

The financial institution should record and retain for evidential purposes: the inquiries made; the responses; any additional evidence or documents obtained; and the conclusions that are reached.

Sunil Gadhia is a partner, and James Brady is an associate, at Cleary Gottlieb Steen & Hamilton LLP.