

## Guidelines for AML risk prevention in equity markets

Financial markets today are characterised by a high degree of globalisation, depth and liquidity as well as the large numbers of investors and intermediaries operating in them. This has led to highly sophisticated operations such that there is frequently a long chain of transactions along which the nature of the financial assets involved may change and funds and securities can move rapidly. This sophistication has undoubtedly led to gains in efficiency, but also entails an increased risk of the use of securities markets by participants whose goal is not to optimise the returns on their savings but to launder money of illegal origin.

The risk of securities markets being used for money laundering activities represents a danger for the institutions involved and for the financial system as a whole. This justifies the strict policy of preventing money laundering under which regulated institutions are obliged to apply measures to monitor their operations. The aim of these measures is not to create obstacles to the normal operation of the financial markets, but to avoid possible money launderers from bringing the proceeds of criminal activities into the financial system.

In this study we analyse a series of operations taking place in international financial markets in order to point out the vulnerabilities that, in the absence of an effective anti-money-laundering policy, could exist in financial markets. The analysis centres on international operations in stock markets and includes both the trading and settlement stages of transactions.

It should be noted that the description given below is in no way meant to imply that participants in general in these markets are suspected of money laundering.

Rather, the aim of this analysis is to increase awareness of the possible routes by which abuses of the financial markets might be committed so that institutions can continue to tackle money laundering effectively. Clearly, prevention and control are, and will remain, the main means of fighting money laundering. The forms of money laundering or high-risk practices described in this report are not compatible with the regulatory framework applicable to subjects operating in the securities markets. Strict compliance with the applicable legislation and international standards will therefore avoid conduct of this kind. Thus, following in full the 40+9 recommendations of the International Financial Action Task Force, the Basel Principles, or IOSCO principles regarding knowing the customer and controlling the risk of money laundering will clearly prevent this kind of activity.

### Share trading

We will start with an example which, although it does not aim to cover all the possible ways in which chains of transactions can occur in international share trading, it aims to present a descriptive scheme of the process of dealing and the information available at each stage. Thus, let us suppose that a Spanish brokerage firm or investment services company<sup>1</sup> wants to buy shares issued abroad.

The first step is for the customer to give the brokerage firm instructions to buy the shares. The broker therefore has the details of the eventual holder of the shares, the shares for which the order is given, the number of shares and the price the buyer is willing to pay.

The next step is for the Spanish broker to contact a foreign broker with which it has an agreement allowing it to buy the shares in question. In this second step the information held by the foreign

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<sup>1</sup> In Spanish, an Empresa de Servicios de Inversión or ESI, as defined by Law 24/1988, 28 July 1988, on the Securities Market.

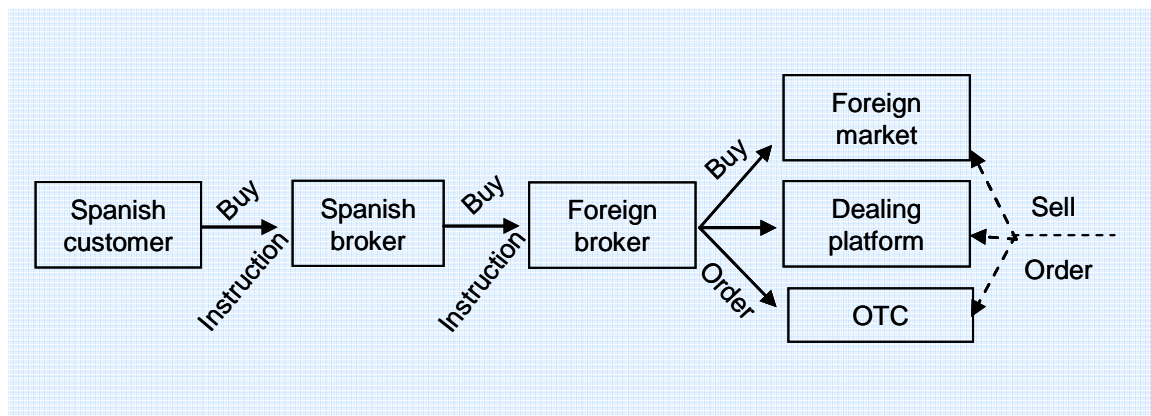
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broker will be the name of the Spanish broker, the shares the Spanish broker's customer wants to buy, the number of shares and the share price.

The third step will be for the foreign broker to transmit the buy order to the appropriate market or platform (foreign organised market, trading platform such as Instinet, or search for a counterparty in non-organised OTC markets), depending on whether the customer wants to buy shares, bonds, etc.

The path followed by the sale order given by the Spanish customer would be analogous.

*Schematic 1. Schematic diagram of trading process*



As a result, during the trade the identity of the final investor may be lost from the second step onwards, making it difficult to track share deals taking place. This difficulty may be increased yet further if orders to buy shares issued abroad are given through a broker in a third country.

The obligation to know and identify customers established by Spanish anti-money-laundering legislation enables regulated institutions operating in the securities market to attenuate the risks arising from the loss of information in these transactions by requiring that procedures be put in place enabling the final investor to be known and identified.

Additionally, the continuous improvement in international cooperation in the fight against money laundering and terrorist financing also means that the control over operations taking place in third countries and territories is ever more effective, making the risks of abuse of the system much lower.

## Settlement

Such a variety of institutions can be involved in the settlement process that it is difficult to encompass all the possibilities in a single schema. Taking as our basis the preceding example, in which a Spanish brokerage gives instructions to buy shares issued abroad, the types of institutions that can take part in the settlement of this share purchase are listed below.

Foreign central securities depository: an institution with functions equivalent to those of the Spanish company Iberclear<sup>2</sup>, but operating in a foreign country.

<sup>2</sup> Iberclear is a joint-stock company that centralises the functions of the former securities clearing service (Servicio de Compensación y Liquidación de Valores, SCLV) which is responsible for the book keeping, clearing and settlement of securities traded on Spanish stock exchanges, the book-entry public debt market, the AIAF bond market, and Latibex, the euro-denominated Latin American exchange. It is responsible for keeping accounting records of securities traded on the stock exchange and takes the form of a "central register" or "first step" register.

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Foreign broker: once it receives its instructions from the Spanish broker, the foreign broker transmits the order to the foreign central securities depository to deliver securities on payment to a “correspondent” institution.

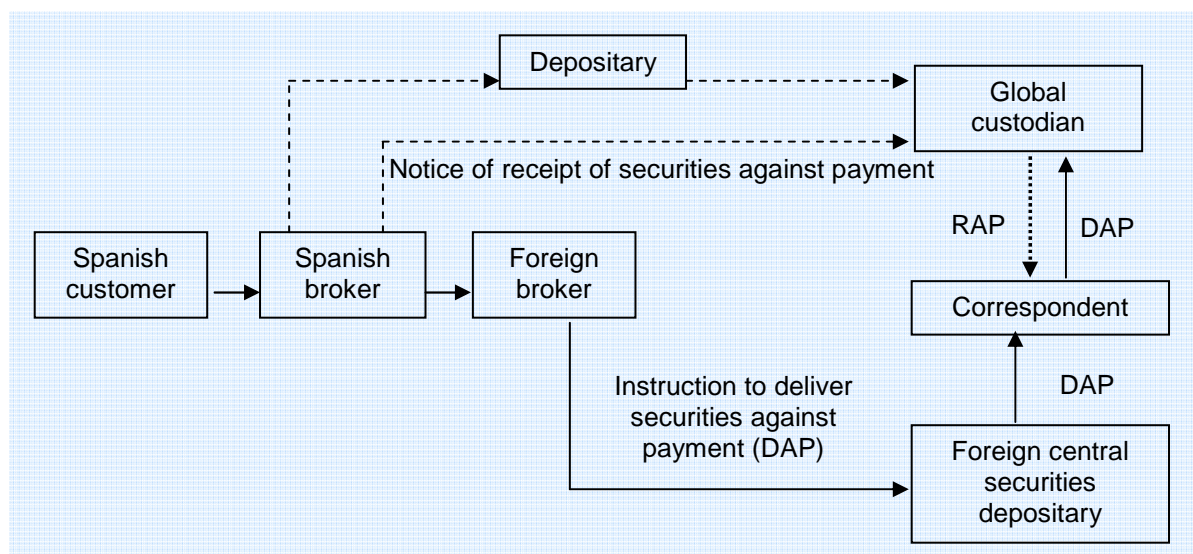
Correspondent institution: a member institution of the foreign central depository from which it receives securities (against payment), when notified of reception by the “global custodian”, with which it has agreements in order to take part in the settlement of transactions.

Global custodian: institution that receives securities from the correspondent (against payment), following notification by the Spanish brokers or another intermediary between the Spanish brokers and the global custodian.

Depository (intermediary between the Spanish brokers and global custodian): it is not common for brokers to have accounts with global custodians, due to the technical requirements necessary to operate in each of their systems. As a result intermediaries (“depositories”) arise which do have these resources and provide the brokers with the service of connection to the global custodians.

By way of summary, remembering that this is not a schema that covers all the possibilities of settlement, the institutions described will be linked in the following way:

*Schematic 2*



It is important to note that each link in the chain knows the previous link and next link but no more. If it is necessary to track or reconstruct these transactions, it would be possible to use the communications between institutions, which are usually sent via SWIFT.

As discussed, the involvement in international trading and settlement of various institutions subject to different regulations and with different functions can make it difficult to follow these transactions and find out who the final investors are as it leads to a fragmentation of the available information. Moreover, the settlement of international transactions through fully disclosed accounts (the institution of which the originator is a customer opens an account in the customer’s name in a foreign institution, through which it channels orders and informs him of the state and value of holdings), or through omnibus accounts (holding securities in the name of various investors), can increase the difficulty of following the whole course of the transactions.

Nevertheless, settlement takes place through the correspondents’ accounts, making it possible for institutions to establish the necessary controls to reduce the risk of money laundering as Spanish anti-money-laundering regulations oblige institutions to apply additional measures to identify and

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know the banking correspondents with which they work, as it includes correspondent banks among the most sensitive business areas in terms of money laundering.

## Nominee accounts

In third-party accounts with Iberclear member institutions there may be securities held by nominee accounts. These are usually institutions created under foreign legislations behind which are global custodians as the holders. The aim of this system is to allow institutions participating in foreign systems to access Spanish shares to trade them in their markets. There are therefore numerous participants in a global custodian, behind which will be customers (institutional investors and private individuals) who are the real owners of the Spanish shares. However the real ownership becomes blurred as soon as the institution participating in the foreign system becomes the holder of the shares in the nominee account, which in turn is the official owner for Iberclear, and therefore, for the Spanish authorities.

Within participants' third-party accounts it is also worth highlighting the existence of "trust accounts" which are usually in the name of the independent trustee or are set up by investment banks abroad or in offshore territories. End customers of these banks frequently use this system to conceal their identity.

It has been shown that through nominee accounts or trust accounts any person or company can hold shares in a market without the authorities responsible for that market having ready access to their identity as international depositaries generally provide only limited information.

Spanish regulations allow open connection accounts with institutions carrying out similar activities to exist on Iberclear, provided certain requirements are met. Foreign depositaries that meet these requirements can open a securities account with Iberclear. This account will show the balances, broken down by security code, that the depositary holds on the system managed by Iberclear.

The purpose of these accounts is to facilitate the cross-border movement of securities for which Iberclear holds the records to other systems and to enable book entries to be made for foreign securities in its records. This is what is known as "connections" with foreign depositaries. Thus, the balance of securities in the accounts Iberclear has with foreign systems is assigned to Iberclear member institutions that intend to trade securities in Spain.

Up-to-date knowledge of the characteristics of correspondent institutions through which the transactions of regulated institutions are settled, the type of business they carry out, and the geographical region in which they operate, make it possible to mitigate the risks of this kind of vehicle's being used for operations relating to the laundering of money deriving from illicit activities.

Also, more effective control over transactions in third countries and improved international cooperation limit the extent to which these vehicles can be used for money laundering and terrorist financing purposes.

## Securities lending

Spanish regulations allow both bilateral securities lending and centralised securities lending.

The bilateral lending of securities aims to meet the specific need for securities of two parties. Iberclear acts only as a register for such transactions as it keeps a register of securities lending in which loans are recorded until cancelled. This is intended to restore to the lender the same references in the register as were entered when the loan was formalised. If two member institutions are involved, both the constitution and cancellation must be notified by the initial holder of the shares concerned.



The biggest market in lending Spanish securities is in London and is structured around foreign bank dealing desks. This implies that the contracts are formalised abroad and subject to the legislation of the countries in which they are deemed to be signed. In such cases all that is known about the transaction comes from the SWIFT notification received by the member institution so that it sets in motion the exchange of securities. As for the parties to the transaction, either individuals or companies (resident or non-resident) may be involved. Foreign institutions involved in transactions of this kind do not usually inform Iberclear of the conditions of the contract or the repayment terms of the loan, thus making it difficult to track the loaned securities.

When securities are lent in the Spanish market, i.e. through Iberclear members, these institutions maintain a register reference<sup>3</sup> stating the name of the holder. It is possible that this holder is not the final owner, in which case it is possible to determine the owner by contacting the regulator in the country of origin stated on the register reference. It is therefore possible to find out who is behind any conduit companies used to hide the owner's identity. It should also be pointed out that the Spanish Stock Exchange Commission (CNMV) has daily access to information on transactions in the market supported with loans of securities, thus facilitating the tracking of each transaction.

In Spain, loans of securities require the same number of shares of the same type and nature to be returned. However, contracts abroad may include clauses guaranteeing repayment of the debt, pledging shares identical to those lent, or other assets enabling the value of the lent securities to be restored. Potential money launderers could borrow shares of one type and guarantee payment in other, totally different, financial assets, including money, and by allowing the collateral to be realised, convert the pledged assets into other that are apparently legitimate. It would also be possible to lend the securities so as to have them off portfolio and then retrieve them (either in the form of the same securities or other assets) when the loan matures. In this way the potential money launderer would have managed to move the securities, and even convert them if there is collateral and it is realised. In short, bilateral loans of securities could be used as an instrument for money laundering if the institutions involved do not adopt the necessary measures to ensure they know the customers, whether banks or otherwise, with which they enter into transactions of this kind.

Centralised loans are those where Iberclear borrows securities from member institutions to cover all the sales pending settlement beyond the normal three-day period. The institutions provide the register reference for loan, and this is restored to them at maturity. They can lend either their own or their customers' securities in this way if the latter have signed a contract with the institution for them to do so.

The mechanism used is for register references to be chosen for loan by a lottery of those marked as loanable. The random selection mechanism means that although a register reference is marked as loanable, there is no guarantee that it will be used in a centralised loan. At all events, the list of lent references and their associated owners is held by the member institution concerned. It is not therefore likely that centralised lending could be used as a means of laundering money.

## Securities pledging

Securities, like other financial assets, can be pledged as collateral for loans granted by credit institutions. However, these tend to give loans for amounts less than the value of the shares in order to cover possible variations in their price.

In the context of money laundering operations it may arise that the holder of the securities applies for a loan or a credit line and then, when it matures, defaults on his obligation to repay the loan and thus allows the lender to seize the collateral. In situations of this kind the applicant usually draws down all of the money fairly quickly and the financial institution seizes the collateral at maturity. This

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<sup>3</sup> Transactions involving securities traded on the Spanish stock market are numbered by the governing bodies. When securities are passed to a new owner as a result of a purchase, change of holder or inclusion, the transaction number becomes the "register reference".

means securities are being exchanged for money of legitimate origin and the potential money launderer obtains the money well in advance of the change in ownership of the securities.

If securities are pledged as collateral, Iberclear has no knowledge from its records of the rights held over them, unless they are pledged to the Bank of Spain or MEFF<sup>4</sup>. It is usually the financial institution to which the customer has applied for the loan that asks for the securities to be transferred to its member's third-parties account to avoid their being sold. However, in the case of fixed-income securities (whether public or private), Iberclear does register the fact that they have been pledged as collateral.

The inclusion by regulated institutions of transactions of this kind among those that are at risk of being used for money laundering purposes should promote more detailed analysis of them in order to confirm or rule out their possible links with money laundering.

## **Transfers of securities**

Member institutions of Iberclear can transfer securities from the account of one member to that of another provided the ownership of the securities remains unchanged. If it does not, the operation should take the form of a sale or change of owner. During the transfer the same register reference is kept and the securities will be detached from one account to be associated with another. Two kinds of transfer can be distinguished: those against payment and those without payment.

Under Spanish regulations the holder of the securities may request their transfer from the member institution with which they were initially registered to another member. Transfer takes the form of a transfer without payment because there is a movement of securities, but not of cash, between the members' accounts. In effect the securities move from one third-party account to another within the first step register in Iberclear. For the purposes of money laundering, a series of changes in the account where the securities are held could make them difficult to trace. However, Iberclear must be notified of these operations and so can reconstruct the route followed by the securities.

Transfers against payment constitute a type of transaction commonly used by non-residents settling through institutions other than those holding the owner's securities account. The transfer of securities necessary to settle the transaction tends to require the simultaneous transfer of cash in the opposite direction.

In the case of either type of transfer Iberclear must be notified of the transaction by both the members involved, making it possible to retrace the route through the various institutions in whose third-party accounts the shares have been held.

## **Internalisation of orders**

In the Spanish stock exchange orders to buy and sell shares are channelled through market members, who bring them together at the stock market thereby "concentrating orders". One way of looking at this would be consider there to be a single order book for each security code where all members' buy and sell orders are brought together. By contrast, the Spanish public debt and private fixed income markets are by definition decentralised (i.e. not concentrated).

The concept of internalisation of orders is that there are institutions that, although the centralised market exists, choose not to use it, but instead match buy and sell orders between their customers.

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<sup>4</sup> MEFF is the official Spanish futures and options market and forms part of the holding company "Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A."

It is common practice among foreign investment banks for them to have their own order books where they record and match customers' buy and sell orders, thereby enabling them to buy and sell shares without any control by the authorities. In effect the final investor may change, but the shares remain within the sphere of the investment bank and for the purposes of clearing and settlement, the bank is still the holder at the first step in the system. All that reaches the market are the residual transactions it has not been possible to match internally.

Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004, on markets in financial instruments permits investment companies as defined in the scope of the directive to internalise orders. At the same time, it highlights the ad hoc and irregular nature of internalised transactions and subjects "internalisers" to specific obligations to publish prices.

The directive therefore opens up the possibility of executing orders outside a regulated market, although it also gives internalisers the right to suspend or refuse to enter into commercial dealings with investors, based on arguments such as the investor's financial situation, counterparty risk or the final settlement of the transaction.

From the point of view of money laundering, the phenomenon of internalisation would enable successive conversions of funds into shares and shares into funds, erasing the trail of the money and making it difficult for the authorities to trace. We would find ourselves confronting a new case in which financial markets could be used to launder money by covering its tracks.

The implementation of internal control procedures, pursuant to anti-money-laundering regulations, should allow institutions that internalise orders to establish the filters necessary to analyse these transactions from the perspective of their possible use in money laundering processes.

## **Transactions with illiquid securities**

The intention is to use shares in small listed companies with financial problems as an investment instrument by moving the share price in order to launder money and repatriate funds.

Money launderers seek out a small listed company in need of funds and send a representative who offers to solve their financial difficulties arguing that he wants to back the company's strategy.

Through a paper company (company A), funds from a tax haven are invested in the company in exchange for shares (this may entail a capital increase). The share price will be low as the market knows that the company is in difficulties.

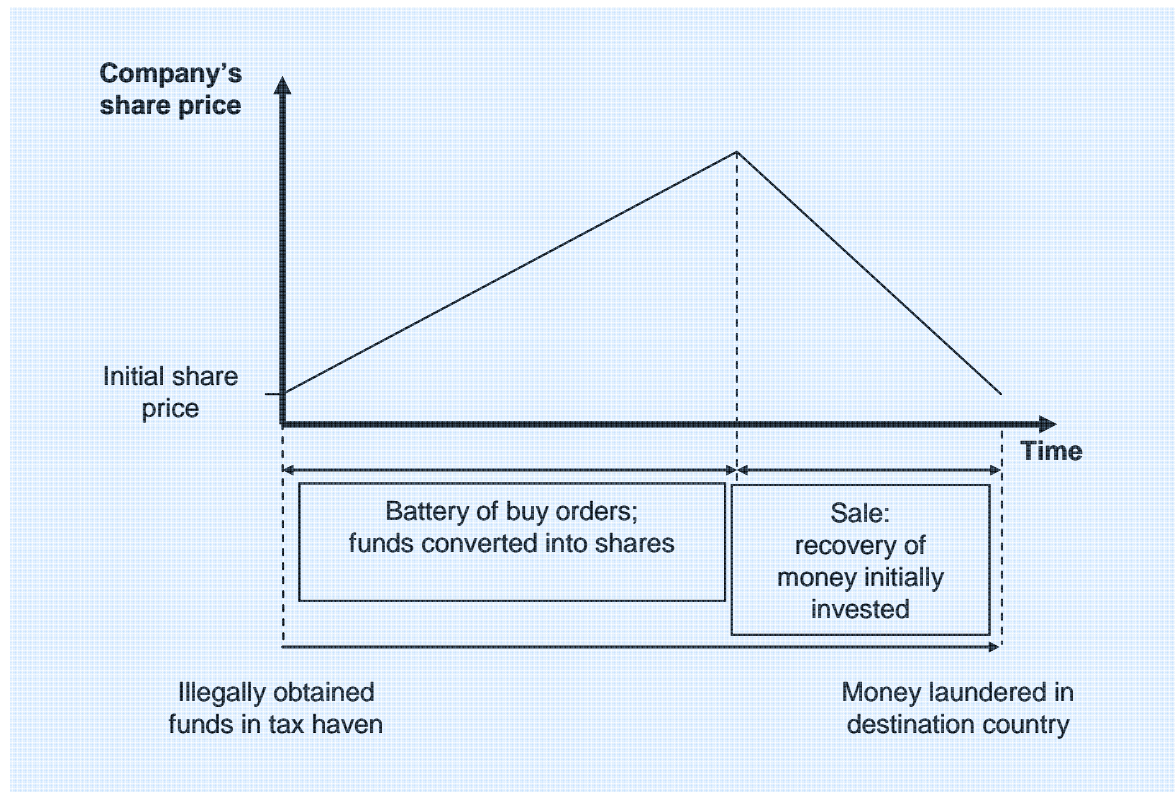
Then, a second company (company B), located in the same country as the company being bought, starts to issue buy orders for its shares through a broker. This pushes up the price. As the shares are illiquid, it is effectively company A that is selling its shares to company B. The increase in share price could be justified by issuing fictitious press releases giving good news about the company.

When company B has bought the necessary shares it gets rid of them by selling them back on the market. They will probably be bought by speculators or investors who are hoping for a similar bounce back in the future.

Through this operation the money launderer's have managed to create an apparently legal source of the illicit funds and repatriate them to the desired country, while at the same time making a profit.



Schematic 3



The signs to watch out for to detect this kind of operation include:

Strong oscillations in the price of a minor share which can only be due to the rapid purchase of large shareholdings. In a more sophisticated operation there could even be a take-over bid for the target institution.

Just two institutions take strong positions. There could also be speculators buying small stakes.

A possible capital increase by the company being "helped", or an issue of convertible bonds.

Use of paper companies, one or more possibly based in a tax haven.

The implementation by regulated institutions of checks to identify these signs will enable a more detailed analysis of operations of this type to ensure that they are not used to launder money.

## Mechanism for assigning profits

The way the market operates allows stock brokerages not to break down transactions at the time of dealing, meaning that the possibility exists to reassign the results of transactions between originators in the way desired. Among the multiple combinations possible, an example will be given to show how this concept can be applied to transfer profits, and therefore, funds.

Let us suppose that a particular individual is the authorised representative of two companies (A and B) and is interested in transferring funds from one to the other while giving these funds, as far as possible, the appearance of a legitimate origin.

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In order to avoid raising suspicions, both companies would need to be customers of two stock brokerage firms (broker 1 and broker 2). Through these brokers they give the following orders on the same security:

Company A gives an order to buy shares at 9 euros each through broker 1 and simultaneously gives an order to sell the same share at 9 euros through broker 2.

Seeing that the shares have risen to 10 euros, company B issues a buy order at 10 euros through broker 1 and a sell order, again at a price of 10 euros, through broker 2.

At this point the authorised representative tells broker 1 and broker 2 to assign the profits from the deal in the following way:

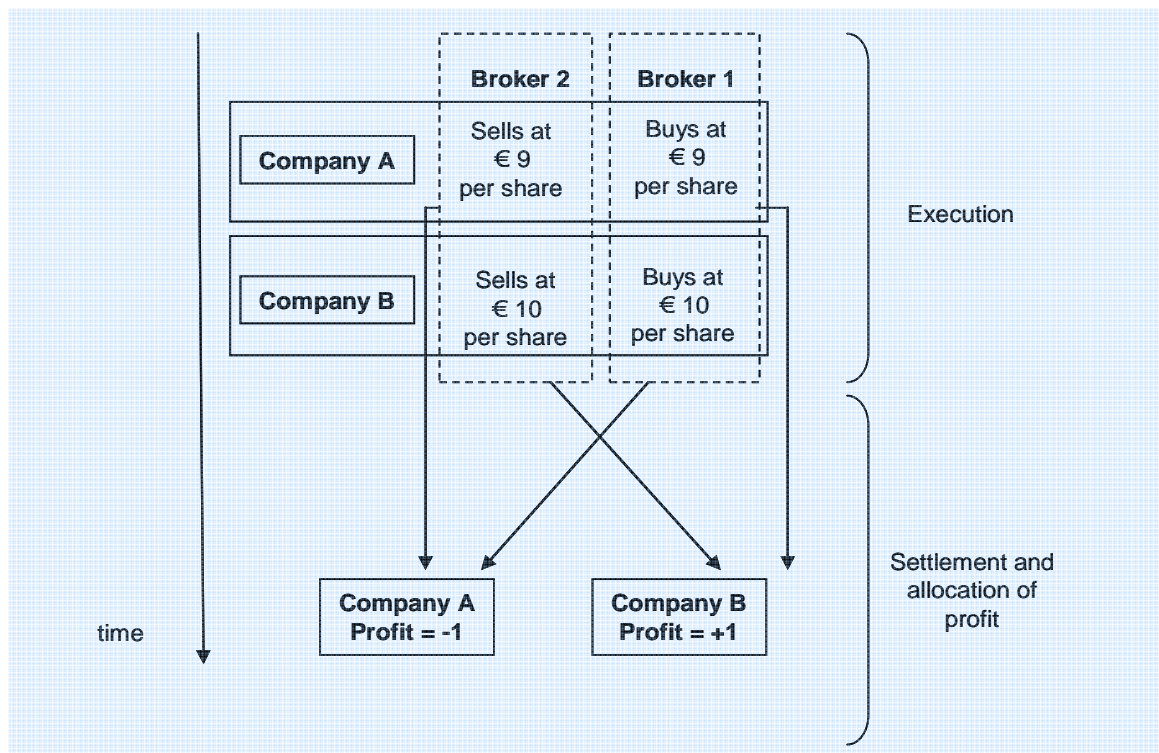
The sale at 9 euros and the purchase at 10 are to be assigned to company A, so that this company pays a loss of one euro per share and registers it in its accounts.

The sale at 10 euros and purchase at 9 euros are assigned to company B, so that it receives a profit of one euro per share and registers it in its accounts.

The result is that by means of two transactions one euro per share has been transferred from company A to company B and given an apparently legitimate origin, as the funds derive from share dealing.

If the transactions were also settled through two different clearing systems, the process would be even more difficult to trace. To summarise:

*Schematic 4*



The procedures that need to be implemented by institutions under Spanish regulations regarding the requirement for them to have up-to-date knowledge of the business and professional activities of their customers and to subject all complex or unusual transactions, or those without an apparent legitimate economic aim, to particularly close examination should make it possible to detect transactions of this kind and enable measures to prevent them taking place being adopted.

## Conclusions

The foregoing analysis has shown that it would be possible to use equity market transactions to launder money by concealing its origins. It should be noted that the anonymity customers can achieve by dealing in equity markets through financial intermediaries can be attenuated to a large extent by the existence of accounting records held by both Iberclear and the brokers.

From an international perspective, the chain of transactions executed through international brokers, settlement through global custody and settlement institutions, and the use of omnibus and nominee accounts can make it extremely difficult to track money and ownership.

Commonplace transactions such as the lending, pledging or transfer of securities make it possible to conclude that the equities market may be used to move funds and change them from one type of asset into another, with or without a contra item.

Moreover, as brokers are not required to give a breakdown of transactions at the time they take place, it might be possible to create mechanisms of profit and loss allocation that enable money to be transferred from one person to another. It is also worth noting that mechanisms such as the internalisation of orders only increase the possibilities of opaque transactions and concerted actions. Lastly, there are techniques that can be used to hold assets in a way that gives them an apparently legitimate origin.

From the foregoing we can surmise that the structure of trading and settlement in equity markets and their most common transactions can be used as a means of laundering money by concealing origins and integrating money with legitimate financial flows.

Spanish anti-money-laundering legislation requires regulated institutions that operate in the securities market to comply with a series of obligations, at the core of which is that of knowing and identifying customers. This does not concern formal aspects alone, but also extends to the identification of the end investors in those cases where customers are not acting on their own behalf.

Strict compliance with these obligations by regulated institutions, and the support and promotion of international agreements allowing and encouraging transparency in financial markets and information exchange, need to be the fundamental pillars supporting efforts to control the risk of money laundering through equity markets.

Madrid, December, 2004.

