

## NEW TRENDS IN COMBATING FRAUD AND MONEY LAUNDERING: SOCIAL STATUS LAUNDERING

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### ABSTRACT

*This paper presents a new approach to integrating anti-fraud and anti-money laundering controls into one single financial crime prevention and early detection policy. The current best practices, as illustrated by the regulations such as the Fourth Anti-Money Laundering EU Directive shift the focus to the legal aspects of incriminating money laundering as a separate and following offence, usually after the underlying crime has been charged. In contrast, this paper takes a management viewpoint, rather than the legal one, and explores the benefits of prevention and early detection by observing the red-flags such as the social status laundering alerts for tell-tale of possible frauds which need closer examination. The author promotes a linear equation (with fraud and money laundering variables) which is balanced by the newly introduced parameter called Social Status Laundering. Hence, the author shows that ultimately all fraud leads to money laundering alerts and so by installing anti-money laundering controls (alongside the anti-fraud controls) organisations would be able to better prevent deviant behaviour and detect fraud more efficiently. However, the anti-money laundering controls should be dealt with caution as it may interfere with personal privacy.*

**KEYWORDS:** *fraud, money laundering, social status laundering.*

**JEL CLASSIFICATION:** *D23/L22, D81, M14, M53/J24, M54.*

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### 1. INTRODUCTION

**The current legal developments** do not have in scope a systemic, integrated anti-money laundering and anti-fraud prevention and deterrence framework - hence the need of a proper theoretical background in the field. This paper attempts to shed some light into the setup of the modern management of the anti-fraud and anti-money laundering theory by making the use of money laundering alerts the smoking guns for underlying crimes, and by introducing social status laundering as the new parameter to balance the "money laundering alert" equation and to show that ultimately all fraud leads to money laundering alerts. Thus, a logical connection can be done between all the anti-fraud controls and the anti-money laundering ones, and everything could be managed commonly under the wider roof of the money laundering alerts.

Most of today's regulations in terms of money laundering are based on the Financial Action Task Force (FATF) Recommendations (FATF, <http://www.fatf-gafi.org/topics/fatfrecommendations/documents/fatf-recommendations.html>), which represent the international standard setter. With their latest revision in 2012, the Recommendations introduced tax fraud as a predicate offence to money laundering and also encouraged countries to effectively criminalise acts of money laundering whilst establishing the widest range of predicate offenses. In reference to money laundering, predicate offence is the crime whose proceeds must be converted

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into a legitimate form. At a minimum, FATF recommends that any serious offence should constitute a predicate offence.

To transpose the FATF Recommendations into enforceable regulations and to keep up with the latest developments in the field, the EU proposed The Fourth Anti-Money Laundering Directive (Feb, 2013) which was ultimately adopted by the European Parliament (May, 2015) ([http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2015.141.01.0073.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.141.01.0073.01.ENG)).

**There are a few issues** with the above mentioned initiatives. Firstly, they rather focus on the legal aspects of getting the offences incriminated and thus thresholds need to be set and observed. Although this is *legally* right, it does not solve the *managerial* issue of confronting crime in general and fraud (as non-violent crime) in particular. From an economics standpoint, fraud should be dealt with regardless whether it was below or above the threshold to become incriminated. Even if an offence starts out small there is always the danger of entering the crime vortex, where it is likely that the seemingly trivial frauds are followed by increasingly larger and more serious ones. Furthermore, organisations seek a fraud-free status in order to recycle a proper ethical behaviour which eventually sums up into better financial results. Therefore, organisations are focused on fighting fraud in order to stop their financial loss and they do that beyond the legal implications of the offences. Their concerns regarding fraud are backed by scientific research: organisations worldwide lose an estimated 5% of their annual turnover to fraud; it takes time and effort to detect and combat fraud (about 18 months pass since the fraud commenced until it was discovered); 58% of the victim organisations have not recovered anything from fraud, and only 14% reported a full recovery (ACFE, Report to the Nations on Occupational Fraud and Abuse, 2014, <http://www.acfe.com/rtnn.aspx>).

Secondly, by incriminating money laundering on top of the underlying crime (predicate offence), the regulators set the flow order so that the predicate offence gets incriminated first, and then it is followed by the money laundering offence as a separate count. This logic may actually be the opposite of what the authorities originally envisioned when trying to bring the likes of Al Capone to justice.

The origin of the term “money laundering” is uncertain, but most experts believe it was coined in the 1920’s America, a time of prohibition when breaking the alcohol and gambling ban would make very lucrative (and very illegal) ventures. Thus, the proceeds of those unauthorised activities should have been converted into legit-looking ones. However, those legally-appearing proceeds were standing on feet of clay and the prosecutors were able to prove just that when they convinced the jury that the assets of Al Capone, for instance, were much higher in value than the legal sources of revenues which he produced – and therefore he should have had other sources of income which were hidden from the IRS (tax authority) and thus he committed tax evasion, a punishable offense (Al Capone’s Tax Trial and Downfall, retrieved 30.08.2015, 10:45 hours, <http://www.myalcaponemuseum.com/id146.htm>).

Hence, money laundering was used as a circumstantial evidence to a possible and probable underlying crime (fraud) which was not discovered, but which produced effects visible in the discrepancy between the legally-looking assets and the legit sources of revenues. In other words, money laundering, the tip of the iceberg, was visible first and led to an investigation which could prove beyond reasonable doubt that an underlying offence (which was otherwise either undiscovered or hard to prove in court) took place.

**This paper would like to revisit** what the author believes it was the original use of the prosecution’s tool called money laundering: an alert, a red-flag which should trigger further analysis to uncover the real cause of an event.

Under the circumstances, the author delineates two modern approaches to money laundering:

- The classical (legal) approach, established by regulations, which incriminates money laundering as a separate offence, additional to the underlying crime,

- The social laundering approach, where money laundering is used as an alert to a possible fraud, which is visible in the changes of the suspect's social status.

While the legal approach to money laundering tackles the judicial aspects of serious offenses (drugs/ human trafficking, weapons smuggling, corruption, tax evasion) and while it has been lately enforced in closed links with combating terrorist financing, the social laundering approach is meant to help organisations prevent and detect fraud more efficiently by installing money laundering controls alongside the anti-fraud controls.

The main anti-money laundering controls i.e. "Know Your Customer" should be converted by organisations into "Know Your Personnel". From formal background checks and social media profile monitoring of all people involved in, or in contact with, the organisation, to informal socialising of its members, organisations should be able to determine the social status of their personnel. Any suspicious changes in social status would trigger an anti-money laundering alert of a possible underlying fraud which should be investigated.

## 2. THE MONEY LAUNDERING ALERT EQUATION

The author introduces a simple linear equation  $y=ax+b$  to express the money laundering alert. The variable  $x$  is fraud (the underlying offence),  $a$  is the fraud's threshold to become incriminated and  $b$  is the social status laundering. Thus, the equation becomes

$$MLA = i * f + SSL \quad (1)$$

Where:

MLA = Money Laundering Alert

$i*f$  = incriminated fraud

SSL = Social Status Laundering

The novelty of the equation is the social status laundering. Although the wording is similar to money laundering, yet social status laundering is always a red flag and not a crime. Social status is viewed here as the everlasting efforts of someone to appear socially respectable and to trigger appraisals from the community both in terms of moral behaviour and in terms of financial success. It is closely related to the public image that everyone is trying to promote and polish about themselves. The laundering of the social status is seen in the changes, often unexpected, of someone's social status (see equation 2 below). Those changes should cause at least some raised eyebrows if not further investigations in the cause of the changes.

$$\Delta SS = SS \ t2 - SS \ t1 \quad (2)$$

Where:

$\Delta SS$  = The change in Social Status;

$SS(t2)$  = The level of perceived Social Status at the time moment  $t2$ ;

$SS(t1)$  = The level of perceived Social Status at the time moment  $t1$ , previous to the above mentioned  $t2$ .

The inquiries into someone's changes of their social status should not be regarded as of criminal nature only. After all, each one is given the benefit of the doubt. Instead, the examinations should look into the possible shared benefit of the cause which may produce social status increase to further members of the community. For instance, when a humble mayor of a small town is all of a sudden seen driving an expensive car and moving into a larger house, much beyond his means, people would wonder and might suspect corruption. However, if a closer examination revealed that his wife, a known stock exchange investor has made some successful transactions and earned a small fortune, then everything is all right. In this case social status laundering revealed no signs of

fraud ( $i * f = 0$  because  $f = 0$ , as per equation 1), but a possible raw model to follow by anyone in order to increase their social status: stock exchange investments. On the other hand, if the investigations showed that the company owned by the mayor's wife earned a number of public procurement contracts due to bid-rigging and conflict of interests, then the social status laundering was the sign of the underlying and hidden fraud of the mayor who signed off those contracts for his wife's company.

Social status laundering appears in two ways, one being the move to an upper social level due to increase in wealth, for instance, and the other being keeping the current level even though major circumstances occurred and should have eroded that level. For example to the latter case, if a couple of respectable parents in the community both lost their jobs and yet continue to show the same life style, then a closer look should determine whether the decrease in parents' earnings by losing their jobs was balanced by legit sources such as previous savings, or financial support from the children (who are grown adults with good incomes), or whether the parents have got other sources of income which were hidden and which raise questions whether tax evasion was done or whether a whole illegal activity was secretly undergoing.

To conclude, someone's social status laundering is always the subject of public scrutiny in order for the community to preserve the achieved level and continue to prosper. As long as we are social beings we will always be assessed by the peers. And since we do not live in a perfect world, there is always the danger that fraud would undermine the common good - which should make all of us alert to fraud signs.

Going back to the equation (1), social status laundering may be the only way we could spot deviant behaviour, by triggering a money laundering alert:

$$IF i * f = 0, \text{ then } MLA = SSL \quad (3)$$

It is important to remember that we are dealing with alerts rather than offences. A money laundering alert is only signalling the need of further investigations in order to discover whether an underlying crime was committed or not. If indeed was, then we deal with the fraud itself, plus the money laundering as an additional offence. Thus, money laundering evolved from an alert into an offence. However, for management purposes, it is irrelevant whether money laundering is a crime in itself. Organisations are mostly concerned with stopping fraud which is directly affecting their bottom line. Dealing with fraud means both prevention and deterrence. The latter implies detection and discouragement of future similar actions, by installing additional controls as well as by punishing the fraudulent behaviour in order to show that fraud is not tolerated and should not be repeated. Real life situations proved that deterrence is costly and never 100% fraud-proof (AFCE, Report to the Nations, 2014, op. cited). Therefore, the focus should be on prevention and early detection and the author believes the money laundering alert equation does just that.

Furthermore, the equation (1) is useful in today's world because there is a certain degree of confusion and overlap when it comes to complying with the relevant authorities which combat financial crime. The latest regulations such as the Fourth Anti-Money Laundering EU Directive, based on the revised FATF Recommendations (2012), do not produce a coherent layout of fraud and money laundering in an integrated framework. Consequently, in some EU countries like Romania fraud is handled by the tax authorities (ANAF – Agenția Națională de Administrare Fiscală, [www.anaf.gov.ro](http://www.anaf.gov.ro)), via its anti-fraud direction, whereas the anti-money laundering is supervised by a different regulatory body, ONPCSB (Oficiul Național de Prevenire și Combatere a Spălării Banilor, <http://www.onpcsb.ro/>).

Yet, both regulatory bodies mentioned above work with similar requirements and so the private sector complains of the redundancy and the increased bureaucracy in complying with each separate body for the same or very similar issues such as suspicious transactions over the legal threshold

(Capital Magazine, 27 Apr 2015, <http://www.capital.ro/fiscul-noul-big-brother-obliga-avocatii-contabilii-si-consultantii-sa-si-denunte-clientii.html>).

**The author proposes an integrated approach to both anti-fraud and anti-money laundering**, by using the money laundering alert, presented in equation (1), which solves the situations when fraud would not visibly lead to money laundering either because it is below a legal threshold or because the offence is intricate and/or not covered by the criminal law ( $i*f = 0$  because  $i = 0$ ). One example of such fraud with no visible money laundering effects is the LIBOR fixing scandal (London Interbank Borrowing Offered Rate) sparked in 2012 (Financial Times, 27 July 2012), where some banks reported false levels of their interest rates either to make profits from the trading, or to give the impression that they were more creditworthy than they were (USA Today, July 2012). Another example on topic is the misuse of company assets for personal purposes, or even asset misappropriation for personal consumption. In these cases there is no conversion of ill-gotten assets into the legal economy and therefore money laundering, in its classical definition, is not visible. Yet, the social status laundering could activate investigations to uncover the frauds and the money laundering would be exposed in the form of the fraudster's **intent** to use misappropriated assets as if coming from legal sources like personal purchases. Yet, since those assets were not purchased, there was no value-added tax or sales tax paid and therefore we are dealing with tax evasion.

The same sort of examples may be applied to larger scale, even to organisations as whole entities. In the case of financial statement fraud, where relevant staff manipulate financial statements not for their direct personal benefits, but for the organisation to appear financially stronger (and thus get easier access to funding), money laundering is again not apparent – but social status laundering is. Here we may not seek the sudden unexpected changes in social status or behaviour, but ask ourselves about the grounds leading to such solid financial position. Is there a strong foundation for those results? If not, then the proceeds of the organisation's activity could be considered money laundering because they come from fraudulent behaviour (deceit or guile by financial statements manipulation), even though the source of funds itself was legit.

In such circumstances, the  $i*f$  (or "if") element of the equation (1) is equal to zero. The beauty of the equation is that all of "iffy" leads to money laundering are nicely balanced by the SSL. In the LIBOR fixing mentioned above, banks which performed too well compared to fundamentals should have hit the alert of social status laundering (they were too good to be true) and once the iffy fraud uncovered, the proceeds would have been deemed as money laundering because it came from illegal financial activities.

**To conclude**, the SSL allows all types of frauds to produce leads to money laundering alerts and therefore organisations and even countries could establish integrated policies to combat financial crimes under the wider umbrella of money laundering alerts.

### 3. IMPLICATIONS OF IMPLEMENTING MONEY LAUNDERING ALERTS

The implications of implementing the money laundering alerts range from small scale organisations to entire country policies. In either case, the most important money laundering control to work with is "Know Your Customer" which becomes "Know Your Personnel" in the integrated anti-fraud and anti-money laundering framework. To recall, the anti-money laundering controls should supplement the anti-fraud controls rather than replace them – so that by applying both types of controls organisations will increase the effectiveness of financial crime prevention and detection.

Know Your Personnel controls could be formal and informal. The formal ones may deal with the official background check of all employees as well as with a continuous monitoring of their social networks activity. The informal ones may be loose and could be applied in day-to-day chit-chat, company social events (parties, celebrations), and team-building, outdoor activities and so on. The purpose is not to spy on one's private life, but simply to set up a social status benchmark for further assessments of social status laundering.

The controls should evaluate the most important fraud risk factors: living beyond one's means, an overwhelming desire for personal gain and high personal debt (Albrecht et al. 1984).

The ultimate purpose of the money laundering controls is to verify one's source of funds. Any direct verification may pose privacy issues and therefore in most cases an indirect assessment is attempted, by observing the life style of the subjects in contrast with their known income sources. Any discrepancies should trigger a money laundering alert. However, there are cases when discrepancies are small and hard to detect.

The social status laundering, just like any other isolated fraud control, has got its fair share of limitations. The solution is to apply a wide range of controls in an integrated scheme so that one's limits could be covered by another. For instance, in the case of small fraud of asset misappropriation, when someone is misusing company's computer for personal purposes, or company's phone for private calls, or when someone is "borrowing" company's printer cartridges and use those at home for personal print-outs, it is difficult to spot the social status laundering, unless there is an intimate eye-witness to testify. Some organisations don't even bother to address those small instances of fraud and even consider them indirect benefits to employees – as long as everything stays small and under supervising control. In contrast, other organisations would seek to cut-off the evil roots regardless how small and underdeveloped, and cultivate an appropriate ethics behaviour throughout all levels of the organisation, in belief that ethics should work when everything else fails. In fact, installing additional anti-money laundering controls on top of the anti-fraud controls would increase the perception of detection, which is one of the most effective preventive policies (ACFE, Report to the Nations, 2014, op. cit). This is how the integrated anti-fraud and anti-money laundering system of controls will also help prevention and not only detection.

The social status laundering may be used at larger scale, as country's policy, for instance. People who show a life style much beyond their visible means may be subject to cross-examinations in order to determine whether their revenue sources are legal.

There is however a thin line with respect to the legal grounds of investigations: people do not need to prove they are innocent; instead, the prosecutors need to gather evidence and the courts will decide whether anyone is guilty. The gathering of evidence, in turn, may pose privacy challenges and we get back to square one where people should be given the benefit of the doubt.

A possible solution would be the wide implementation of the integrated anti-fraud and anti-money laundering framework (based on the social status laundering alerts) across organisations. People will eventually see it as a way of life, of preserving the common good and of deterring criminal behaviour. After all, the thorough security checks at the airports *are* an invasion of privacy of otherwise innocent until proved guilty citizens. Yet, everyone accepts those security checks in order to mitigate the risk of a terrorist attack, even though the whole concept of privacy would have to be addressed and adjusted.

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