

AML/KYC Issues in M&A & VC/PE

When investing in another firm or when acquiring an operation in another country, looking at money laundering and terrorist financing risks can prove to be a significant cost saver, as Jay Jhaveri, Director Asia, World-Check explains. This feature provides an overview.

The issue of money laundering and even front businesses for terrorist financing can be viewed from two perspectives: the investor company and the firm being invested in. This article will proceed on the assumption that the investing company's funds being invested are clean, while the company being invested in needs to be reviewed from an anti-money laundering /combating the financing of terrorism (AML/CFT) perspective.

The Regulatory Perspective

The AML/CFT laws of the land which typically cover all industries may or may not be reflected in regulatory rules that create specific requirements for controls in a M&A or Venture Capital/Private Equity (VC/PE) investment.

M&A activity can exist in any sector of business and hence depending on the sector, it

may (or may not) be regulated with a supervisor and hence may (or may not) have specific regulatory guidance. VC/PE players are often provided guidance for AML/CFT by their industry bodies, for example, the US National Venture Capital Association.

Even if regulated, regulators would have a different stance if the entity being acquired/ merged or being invested in was locally incorporated (or in an 'equivalent' jurisdiction) or incorporated abroad in a non-Financial Action Task Force (FATF) member jurisdiction.

- Regulators do not insist on re-identification of existing customers provided that all customer account

records are acquired with the business and due diligence on the acquisitions AML/CFT policies, procedures and controls leads to a condition where the acquired business has satisfied the



supervisory standard of the acquiring entity ie, this usually means FATF member countries albeit some supervisors may insist on excluding some high-risk countries from this “equivalence” definition.

- In general for entities incorporated abroad, it is advisable to do a due diligence on the country money laundering/terrorist financing risks understanding the intrinsic risks (eg, countries prone to corruption, tax evasion or terrorism), the risks generated by poor regulation for AML/CFT (eg, the FATF Non-Cooperative Countries and Territories (NCCT) black listed countries, other poorly regulated countries), and if poor risk management practices exist in the entity being acquired. If the entity being acquired does not satisfy the supervisory standard expected, then re-identification/ due diligence on high-risk customers is recommended. This process can be carried out “offline” using non-documentary verification processes with minimum customer service implications.

Irrespective of whether the business is regulated or not, best practice dictates that as part of the due diligence process of a M&A or a VC/PE transaction, money laundering and terrorist financing risks are taken into account.

Terrorists are finding it difficult to rely wholly on charities as a source of funding and are now working with drug traffickers and criminals to generate and launder monies for their use. Front companies, particularly if the business is a cash intensive one, are an important typology for money laundering and terrorist financing.

Transaction Risks

Normally M&A activity leads to a larger entity in which effective control is handed over to one dominant party. However, hidden in the offices of the acquired business could



be employees who knowingly facilitate money laundering, even if the top management of the entity being acquired is apparently clean. Furthermore, if the entity being merged /acquired is a financial institution, bad risk management practices could lead to transference of risks to the dominant party. Hence risk management and Know Your Customer (KYC) reviews of the client base are very relevant. Know Your Employee (KYE)

reviews are also relevant including making decisions to let go of employees found to be suspicious. Naturally their account portfolios would then go through a through scrutiny.

In the case of VC/PE type investments, the investor only takes an equity position and does not get involved in day-to-day operations of the company. Hence this

exposes the investor to the risk of investing in a front operation that is not in their control. This risk gets enhanced where the company is not a listed one and is a private limited company in a business regarded as high-risk for money laundering and in a country that has key risks. The opportunity is also there for the existing owners to misuse the investors brand to further the perception of a respectable organization and, for example, to use this to facilitate bank loans.

Risk Management

Rohan Bedi, Head of AML Services for PricewaterhouseCoopers in Singapore and author of *Money Laundering – Controls and Prevention* states “Without going into details of an AML/CFT framework for an institution, generally for good risk management practices a focus should be on the three anti-money laundering risk models – geography and country, business and entity, and product and transaction.

For example, the Transparency Internationals Corruption Perception Index can indicate that the country that a firm is investing in is prone to corruption. The business being invested in, for example, jewelers, is high risk for terrorist financing. The company being invested in, for example, has a company director and company shareholder holding 10% of the equity which on a careful scrutiny leads to many nominee relationships in which lawyers names start to surface as the first layer. This could lead the investor to believe

that there may be an individual trying to conceal his identity through the company ownership structure especially if the 10% equity stake entitles the share holding company to disproportionate voting rights.”

Where the acquisition is of a trust administration company, due diligence on the trusts operated by the trustee is also necessary.

Case Study 1: Acquisition of a trust administration company

A trust administration company, in a reputed offshore jurisdiction, owned by a prominent bank had been acquired by another international bank and the new bank found itself in the middle of a legal battle that it had not accounted for.

The Three Bases

Institutions need to take a systematic approach to risk that covers all three bases rather than just one or the other.



Geography and Country Risk

Business and Entity Risk

Product and Transaction Risk

The trust administration company administered three trusts on behalf of a Middle-Eastern PEP. The courts adjudged in late 2001 that the trust administration company had colluded with the PEP to mislead the court by keeping vital information from it. The trusts were alleged to have been used to receive hundreds of millions of pounds sterling in bribes or “sweeteners” from arms companies in return for

lucrative contracts in the Middle East. The funds in the trusts had been frozen owing to the investigations on whether they were the proceeds of crime. The PEP, backed by his home state, was seeking to convince the court to direct the trust administration company to

allow tens of millions of pounds still in the trusts to be released.

Had the acquirer's due diligence process been thorough, they may have been saved from a lot of trouble.

Importantly, from the perspective of practical KYC practices, the usage of a good database for politically exposed persons (PEPs), terrorists, official sanction and embargo listed entities and other high risk categories of individuals is essential. This sort of database must be used with a good filtering engine (a name recognition technology) that covers variants like misspelling, juxtaposition and sound-alike.

The definition of PEPs is too wide making it impossible to monitor/ review on a manual basis. PEPs have also been known to have links with terrorists and there is also a link in corruption monies and the diamond trade. These complex links need to be uncovered in order to give the acquirer an idea of the risks that they would take on board.

Suspicious Activity

Broadly speaking, here are some indicators of suspicion where the investee company is a 'self launderer':

- complex corporate structure where complexity does not seem to be warranted;
- complex or unusual transactions, possibly with related parties;



- transactions with little commercial logic taking place in the normal course of business;
- investee company has business activity inconsistent with industry averages or financial ratios.
- investee company has a history of changing bookkeepers or accountants yearly.
- investee company is paying unusual consultant fees to offshore companies.
- investee company shareholder loans are not consistent with business activity.
- investee company makes large payments to subsidiaries or similarly controlled companies that are not within the normal course of business.
- investee company acquires large personal and consumer assets inconsistent with the ordinary business practice of the client or the practice of that particular industry.
- investee company is invoiced by organisations located in a high-risk country

Similarly, the investee company can be a victim to money laundering arising from actions of third parties.

Costs

It makes a lot of cost-benefit sense to do a full fledged AML/CFT review and a KYC check on ownership (for example if a privately

owned bank is being acquired). Further for financial institutions, a KYC check on the customers of the firm being acquired is also needed. In certain sectors which are known for smuggling and linked laundering activities with internal staff complicity (cigarettes,

Case Study 2: US Bank Acquisition of a Latin American Bank

This is a case of a large US bank that acquired a Latin American bank with around 300 branches in the 1990s. The value of the bank had been fixed after around 1 year of due diligence involving a Big 4 accounting firm in order to take account of the bad debt portfolio. Owing to the bad debt portfolio, the Latin American bank's managers were not allowed to extend new credits and they lost many business opportunities and clients during this period.

Just after the US bank publicly announced the final agreement for purchase, the US Justice Department announced a major cocaine money-laundering bust that involved several Latin American banks and bankers. The Latin American bank being acquired was prominently mentioned in the list. The US Justice Department announced its intention to prosecute the banks under US law, with fines of millions of dollars, seizures of bank funds, civil lawsuits, indictments of employees, cease and desist orders, and revocation of the banks' charters to operate in the US.

This announcement caused a lot of chaos as the US bank did not know the extent of the possible liability or the extent of employee complicity (of the Latin American bank) in the money laundering scam. This stalled the deal by three months as the bank's team had

to work on a solution that satisfied the US government and was financially acceptable to them. This delay resulted in a loss of clients and managers at the Latin American bank, and very little new business.

Finally, the US bank made final payment for the Latin American bank, and settled the legal claim by paying a fine of USD 15 million to the US Justice Department. The Latin American bank's name had to be dropped and the US bank's own name used for its new operations. This naturally had a significant impact on the integration strategy and the process, impacting the overall time frames.

Imagine a situation where the US bank had paid for the acquisition and only subsequently discovered that the bank was involved in a money laundering scam!

white goods) broader reviews are also needed of their customer base (wherever possible). Very often such businesses may be having dealers which could be indulging in money laundering/ terrorist financing making a know-your-dealer review stage an essential part of the acquisition.

Importantly, an AML/CFT review process embedded in the broader due diligence process is simply prudent risk management. Imagine a scenario where a bank acquires another bank only to subsequently find out that its customers include persons on the FBI's Most Wanted list and PEPs from high-risk countries, all of whom have laundered their terrorist/corruption monies through the bank. This means that the new entity's management now has the onerous responsibility to give explanations to the government and face

possible fines and significant reputation damage. Some heads would definitely roll.

Rohan Bedi says “In the case of a bank acquisition, besides reviews of the AML/CFT risk management policies, procedures and controls, the quality of the KYC information on file also needs to be reviewed:

- are nominee and trustee relationships explicitly monitored to identify the ultimate beneficial owners?
- has the KYC data on file been updated (at least for high-risk categories/accounts) whenever the overall regulatory KYC standard is enhanced, periodically or based on events?
- are all related accounts grouped to allow for customer level monitoring?
- what is the data consolidation capability ie, does the bank have a comprehensive picture of a clients relationship with it across divisions/ branches?

Furthermore, assuming an acceptable customer data quality, it is possible to screen all customer names (depositors, credit card holders, corporate accounts (including the directors, shareholders, authorised signatories) for PEPs/terrorism risks, in a time efficient manner and cost effectively (merely a few tens of cents per customer). From a cost efficiency point of view consider this scenario: during the screening of say, two million plus customers, the acquirer finds say 0.05% (=1,000) of customers that would be considered "high risk" (either high risk /unacceptable PEPs; terrorists/linked persons; criminals) accounts. The acquirer could either turn down the deal (in the extreme case) or beat down the price on the premise that the "risk" is too high /unacceptable. In any case, the acquiring bank can then be satisfied that

they have conducted a reasonably comprehensive screening on all the customers that they will be held accountable for the moment the deal is through. This comprehensive scrutiny can be applied in all financial services industries: for example, insurance, broker-dealers, asset management.”

Conclusion

Hence, in conclusion, whenever one firm is buying out or investing in another firm, it needs to have a full AML/CFT review process including specifically a KYC review of the firms owners and depending on the industry, a full review of their customers may also be required. Is this a regulatory requirement? It may not be spelt out clearly in law but definitely is a global best practice that can lead to significant cost savings in pricing the deal, in fines saved, and the possible monetized value of the reputation damage avoided.
