

# Good stock market governance in the context of anti-money laundering regimes

by Dr Dayanath Jayasuriya

It is increasingly recognized that the stock market offers opportunities to launder funds. It is also recognized that good governance practices must be the norm in the corporate financial world. Despite increasing recognition on both counts, inadequate attention seems to have been accorded to the type of good governance practices that must be followed by stock market players and stock market regulators to minimize the vulnerability of the stock market being used as a medium to circumvent anti-money laundering controls.

## VULNERABILITY OF THE STOCK MARKET

The stock market is vulnerable to money laundering activities in a number of ways, including the following:

1. One or more individual or corporate investors may be associated with money laundering activities. Occasionally, there may be certain corrupt officials within stock broking firms, stock exchanges and regulatory bodies who may knowingly support those who engage in money laundering activities. Clearing houses and depositories and settlement banks may be implicated if they willingly permit a transaction even if information is available that the funds are generated from an illegal source.
2. The nature of the trading instruments and the purposes for which funds raised through the market are to be deployed may be linked to money laundering activities or to fund the predicate offences such as drug trafficking or terrorist activities.
3. A listed company may be a front for a money laundering operation.

Whilst this list is not exhaustive, it is necessary to recognize that in each of the situations mentioned above, there are underlying factors that facilitate the participation of individuals and corporate bodies linked to money laundering activities. A few examples will suffice to underline how this occurs.

### *Prescreening process*

The registration or licensing of stock brokers and other market intermediaries used to be a routine function for the stock market regulator and the stock exchange, and it is

only in more recent times that stricter standards of due diligence have been applied. A company seeking a listing on an exchange goes through a screening process, but the process rarely captures the receipt or use of any funds linked to money laundering activities. Details of holding, associated and subsidiary companies that are provided at the time of listing may not be adequate to make any judgment regarding the operations of the entire group. Individual and corporate clients are required to furnish personal details to stockbrokers only in those countries where there is anti-money laundering legislation. Securities and Exchange Commissions, stock exchanges and central depositories rarely undertake a detailed search with regard to junior level staff being recruited.

### *Share trading transactions*

Transactions may be funded from money linked to crime, but unless the stockbrokers, the stock exchange, listed companies, banks and the regulators exercise a high degree of vigilance, it will not be possible to track down the source of income or the purposes for which the proceeds will be used. The large volume of transactions on the trading floor can eclipse the occasional transfer that ought to raise a certain degree of suspicion.

### *Listing of IPOs and other instruments*

Listing applications set out only in broad terms the purposes for which the company intends to use the funds mobilized through the IPO and other instruments. This information will generally be insufficient to provide any in-depth understanding of the business operations and business plans so as to be able to detect whether there is any possibility of the funds being diverted for illegal purposes.

### **Compliance and other reports**

Compliance reports by firms of stockbrokers, and other reports such those by audit committees and investment committees and the annual reports of listed companies, may not necessarily accord much attention to the implementation of anti money laundering controls.

### **CONCEPTS OF GOOD CORPORATE GOVERNANCE**

Concepts of good corporate governance are being followed by companies to varying degrees. In the absence of a law or a mandatory code of conduct, a high degree of flexibility is available for a company to decide on the norms and structures of governance it may wish to adopt. The pressure to adopt norms of good corporate governance is mounting due to various problems identified in the wake of major corporate scandals and failures.

The following are among the many underlying and contributory causes identified in post-mortems that have been undertaken:

- accounting deficiencies;
- financial reporting deficiencies (“window-dressed accounts”);
- absence of processes for identifying, assessing, managing and minimizing risks;
- front for organized crime;
- lapses in regulatory oversight
- lack of communication;
- auditors’ negligence;
- failures in acquisition or diversification strategy
- in-fighting within board
- negligence, misconduct or failures on the part of the management

Corporate responses to such problems have been many and varied. Each cause or problem area seems to lend itself to one or more responses. The jury is still out; what works is as much uncertain as what does not work. What has worked for one company in one country has not necessarily worked elsewhere to the same extent. Experience has, however, shown us that there are some essential building blocks without which one cannot construct a solid house of good corporate governance.

### **INTEGRATING GOOD CORPORATE GOVERNANCE PRACTICES INTO ANTI-MONEY LAUNDERING CONTROLS IN THE STOCK MARKET CONTEXT**

Anti-money laundering activities within the stock market can be regulated through a series of measures, rather than through one single measure.

Firstly, there needs to be a better understanding of vulnerable situations; the danger each such situation poses to the economy, to financial institutions and society at large; and of the ameliorative measures that can be introduced. In this connection more attention should be given to the 1992 resolution on money laundering by the International Organization of Securities Commissions Organizations (IOSCO). Each Member State was requested to consider and strengthen the application of the know your customer concept and the procedures for reporting suspicious transactions in the context of securities market transactions. Monitoring and compliance procedures were to be reinforced.

An area covered in this 1992 resolution which has not received much attention in recommendations of certain other organizations that have also addressed the subject of money laundering is that IOSCO Members must ensure that there are procedures in place to prevent criminals from obtaining control of securities and futures businesses. This requires, inter alia, working together with foreign counterparts to share information, a process facilitated by the IOSCO multilateral agreement.

Secondly, compliance officers must be under a legal duty to address specifically in their reports how they monitored compliance with anti-money laundering requirements, and the problems they encountered. Their terms of reference must refer to the specific task of monitoring compliance in relation to these requirements.

Thirdly, there must be meetings held periodically involving all securities market and bank regulators and the representatives of stock market players to address the current state of controls and identify emerging trends and issues of concern. Annual state-of-the-art reports might provide useful information to guide future actions.

Fourthly, audit and investment committees in companies must address the issue as to whether the internal control systems and other risk assessment methodologies in place are adequate to prevent or detect money laundering activities involving such companies, their shareholders or customers, and business partners. It is important that systems in place do not impose requirements which are disproportionate to the objectives sought to be achieved, and that there is a healthy balance.

Fifthly, a “fit and proper” test must be applied where feasible to ensure that institutions such as firms of stock brokers and stock exchanges are run by persons with integrity.

Sixthly, standard business agreements must contain a commitment to avoid possible situations that might lend themselves to facilitating money laundering activities with an obligation to report transactions or situations of a suspicious nature.

In the context of anti-money laundering controls, the challenge for those who deal with the stock market is to

ensure that bridges are constructed between the two vertical control columns on anti-money laundering on the one hand and good corporate governance norms on the other. These should not be seen as parallel streams that never meet; each must reinforce and supplement the other and the collective synergy that is thus generated should yield a bumper crop of good results.

A culture of good corporate governance needs to be fostered not only for the sake of giving effect to a concept

currently in vogue, but also because of our commitment to minimize crime and terror and prevent dirty money being laundered through the stock market. 

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