Next, Kenneth Murray, Head of Forensic Accounting at Police Scotland, concludes his groundbreaking research on the challenge of organised crime. Money laundering and related activities are of serious concern to many CISI members round the world; our understanding of money laundering models must keep up with the reality, and Murray’s frontline experience responsibilities bring Kay’s ‘accessibility and relevance’ directly to our members’ desks.

CONDUCT AND CULTURE IN UK LISTED BANKS

Last but far from least, Dr Paul Cox, Senior Adviser at NEST – the National Employment Savings Trust, the UK Government’s workplace pensions scheme – and his colleague Diandra Soobiah have conducted a detailed study on conduct and culture in UK listed banks. A summary is published here, the full paper is available online and Cox will be discussing the results with CISI members in London on 13 July (and later available on CISI TV).

Without stealing the thunder from what promises to be a fascinating event, staff were a special focus for the survey - they were viewed as the front line of conduct and culture, as well as key touch points for customer experience. The banks the research team met wanted staff to have greater competence, professionalism, integrity, diversity of thought, and ability to break through existing ways of doing. Interviews with professional bodies by Keyur Patel for a 2014 report by the Centre for the Study of Financial Innovation (funded by the CISI) reported similar results. “One part of delivering on that intent was to recruit people who'd taken and passed appropriate exams, who were members of a relevant professional body, and who had different skill sets,” says the paper. “Some banks were purposefully hiring from outside the financial services sector to bring in new types of people and personality, particularly within areas such as human resources, conduct and culture, and business development. Those who'd joined conduct and culture programmes from outside the sector had many ideas they were hoping to take forward. The other part of delivering on the intent was to raise competency among current staff and signal that aiming higher is part of what professionalism and performing effectively now means.

“Many staff metrics were being used to track the recruitment and professionalisation of staff. Professionalisation involved continuing workshops, seminars, training programmes, refresher courses, and exams. Metrics included the number of refresher courses carried out, training programmes completed, memberships of professional organisations, exams taken and passed, and an overall average for the professionalisation of staff.

“With assurance of confidentiality and a more honest and open environment within banks, staff were also being encouraged to speak up about moral and ethical issues, the work environment, colleagues, grudges, likes, and dislikes. Personal conduct and whistleblowing cases were on the rise.”

REVIEW OF FINANCIAL MARKETS

We are always keen to gain access to those ‘accessible and relevant’ papers to which we aspire. Ideas and contacts are most welcome. Please mail or call me with any thoughts.

Thank you
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ABSTRACT

Fiduciary capitalists,\(^1\) such as leading pension plans and endowments, can be influential in aligning the interests of asset management firms with their clients. In the market connecting investment professionals with the information they need to meet client goals, we identify numerous conflicts of interest, but find little action has been taken by asset owners. Interest in the obscure practices surrounding the use of dealing commissions for research has heightened since 2014 due to regulatory scrutiny in the UK and the impending implementation of the second Markets in Financial Instruments Directive (MiFID II) in Europe. The authors make recommendations to guide asset managers and asset owners through a complex information market during this time of dramatic change.

INTRODUCTION

Financial capitalism, the prevalent operating system behind global financial markets, has been highly criticised in the years since the 2008 financial crisis. Despite this, we can find examples where the collective power of asset owners has succeeded in improving end-investor outcomes. Hawley and Williams\(^2\) observe the emergence of an alternative system driven by asset owners acting as ‘fiduciary capitalists’ to improve alignment with end-investors’ long-term goals.

Fiduciary capitalists select managers based on the efficiency of their research utilisation and the total cost of management. As a result, they are in a strong position to call for transparent and objective research spending by asset managers.

We briefly review the forces of change in the information market connecting fund managers to external sources of investment research. Despite its obscurity, this market provides an important link between investment management firms and thousands of research providers, such as brokers and independent firms, around the world. It is also large: estimated to turn over in excess of $20bn per annum.\(^3\)

Our ongoing work with firms, regulators, industry and professional bodies, combined with evidence collected through surveys and interviews, reveals little evidence of fiduciary capitalism in this particular market to date. Asset owners, who represent end-investors and therefore could be expected to reduce agency problems inherent in fund management, have been quiet in this debate. Regulators, entrepreneurs and indeed the buy-side and sell-side firms themselves, appear to be the agents of change.

ASSET MANAGERS REMAIN HUNGRY FOR INFORMATION

Rogers\(^4\) cites the shift to lower cost index-based strategies as a result of fiduciary capitalism. Passive index strategies have grown since the introduction of index funds in the 1970s, and now account for some 14% of assets under management.\(^1\) This does not include fast growing smart beta innovations. Rogers notes the important role played by asset owners in shifting to such strategies to meet investor goals, rather than overpaying for the hope of short-term performance.

Despite the ascent of index investing, active management remains the prevalent type of equity fund management around the world. Indeed, it will do so even if passive management doubles in size. Active management is likely to remain an important segment of equity ownership for decades, much as it prevails in most other asset classes. Active managers need research in order to make decisions in the face of uncertainty to meet investor goals. Buy-side firms therefore have to either produce their own research or buy it from third parties. Most choose ingredients from both sources and the recipe will depend on the availability, quality, trustworthiness and cost associated with each source.

WHAT EXACTLY IS RESEARCH?

Investment research comprises much more than written analyst reports.\(^5\) Customised analysis, quantitative models and analyst time procured to improve the chances of meeting investor goals. While this may be consistent with asset owners prioritising investor goals over short-term alpha,\(^7\) it is perhaps puzzling that scrutiny on research costs, or at least demand for attempts to value research, has not been higher in the past. This puzzle can be explained at least in part by lack of understanding of this complex market, which is briefly explained in the following section.

HOW DOES THE RESEARCH MARKET WORK?

The means of paying analysts for investment research is strikingly different to markets for most other professional services. Investment management companies can charge the cost of research to the funds they manage, meaning that their clients pay for research. This

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3. Frost Consulting Estimates. The UK Financial Conduct Authority estimates the UK market to be £1.3bn.
is done using research commissions that are paid to brokers when shares are bought or sold. Unsurprisingly, most research has typically been purchased using commissions, because this way the fund management company does not bear the cost. Additionally, it is most unusual to find contractual arrangements based on billable hours or specified deliverables.

Fund managers decide how to reward analysts for various research services on an ex post basis, ie, after consumption. A typical broker vote process would involve fund management staff deciding how to allocate commissions at the end of each period (typically six months), on a percentage basis. For example, an equity fund manager might pay a given brokerage firm 7% of her firm’s total commission allocation as payment for research. This information would be translated into a target allocation for the buy-side dealers to execute in the coming period. As a result, research would be paid in arrears. Detailed analysis of a US broker vote process can be found in Maber et al., but such processes no longer comply with UK regulation or European regulation post MiFID II. In 2006, UK regulation created a payment mechanism which allowed research commissions to be paid away to other research providers, thus ending the one-to-one mapping between execution and research relationships. It also paved the way for hundreds of independent research providers. This mechanism, analysed by Haig and Rees and usually called the Commission Sharing Arrangement (CSA), has equivalents in the US and other markets. Figure 1 shows estimated CSA adoption aggregated across US and European markets.

![Figure 1: Adoption of commission sharing arrangements (CSAs) and investment bank research budgets 2005–2017](image1)

CSA adoption (bars; LHS axis) was relatively slow but now accounts for more than half of commission payments for research. Investment bank research department budgets (line; RHS axis) have more than halved since 2008. Source: Frost Consulting

**PROBLEMS ASSOCIATED WITH THE BROKER VOTE**

The traditional broker vote process has a number of problems. First, because the vote payments are percentages of commission paid, which outside the US is typically determined by the trade value rather than number of shares, the price of a certain service in dollar terms can fluctuate from year to year due to changes in funds under management (which is affected by market prices of underlying securities, fund performance and fund flows) as illustrated in Figure 2. The fund manager would be charged more for exactly the same research just because of an increase in stock prices or fund inflows. Second, the fund manager needs to trade in order to pay commissions to the broker, which creates the incentive to trade even if transactions are not required. Traditionally only the executing broker could be paid for research, and brokers competed for bundled commissions on the strength of their analyst research. Third, broker votes have often failed to provide useful feedback to brokers regarding the services required. We have strong evidence that the process has been lacking in detail, accuracy and timeliness. The UK Financial Conduct Authority (FCA) views the broker vote as “inherently flawed”.

![Figure 2: Research commissions before and after the introduction of research budgets. Source: Frost Consulting](image2)

Asset management firms, particularly those operating in the UK, have been moving from percentage-based broker votes to dollar-based budgets. The effect, stylised in Figure 2, is that research spending is no longer tied to the volume of dealing commissions as portrayed by the diagram.

**CURRENT STATUS: A MARKET IN FLUX**

Some 15 years after the influential Myners report, which proposed a ban on research commissions in the UK, the UK regulator has finally succeeded in elevating the importance of the research market. The FCA’s 2011–12 thematic review and subsequent consultation lead in 2014 to clarification on the definition of research and the requirement for the CEO of the largest 200 asset management firms operating in the UK to make a personal attestation regarding the use of commissions for research. By interpreting research as an inducement to trade under MiFID II, it also supported further restrictions on research commissions commencing in 2018. As a result of London’s scale in global investment management, research payment has ascended the ‘to do’ list for asset

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The regulatory spotlight on this area has intensified and is unlikely to diminish.

The UK and some other European regulators have sought to break the link between turnover and research payments. Rising equity markets led to larger assets under management, higher share prices, and often increased turnover, typically resulting in larger research commission payments, even if most asset management organisations consume similar levels of research service from one year to the next. Going forward, payment for a similar service level is likely to vary much less over time.

The FCA is expected to require investment management firms to create Research Payment Accounts (RPAs) based on a research budget that is to be set in advance. The research budget must be independent of trading, thus removing any incentive for fund managers to trade excessively in order to purchase research.

By mandating finite monetary (rather than percentage-based broker vote) research budgets, and encouraging managers to adopt board-level research budget approval processes, the regulators have largely achieved their aim of breaking the link between equity turnover and research payments. The outcome echoes Myer’s call for fund management firms to compete by using research efficiently to meet client objectives. Yet the impact is now far wider than Myer’s UK remit. Research consumers and producers around the world have tightened up policies in this area.

Given the vast change in regulatory environment, and the resulting change in the economics of the research industry, asset owners should now question how their underlying managers are responding to these industry changes. Most asset owners routinely and systematically measure the impact of their managers’ trading decisions via trade cost analysis. The efficiency of execution commissions has been regularly reported to asset owners since MiFID (2007) or before. In contrast, research commissions have typically not been reported. Ironically, the performance impact of sub-optimal execution, which could exceed 100 basis points in only the most extreme cases, is dwarfed by the impact of sub-optimal use of research: poor asset allocation or stock selection decisions could easily lead to underperformance of 100bp per annum or more depending on the strategy.

Many investment management firms have collected insufficient information on their use of research commissions, and as a result have been unable to measure the return on investment of their research spend. Consequently, few have been able to present such information to end-investors. Senior officials at investment management firms consistently report that clients remain generally uninterested in valuing research.

**WHY HAVE FIDUCIARY CAPITALISTS NOT BEEN MORE VOCAL?**

We believe that the following reasons have impeded asset owners from demanding clear and transparent information on the cost and efficiency of research purchased with their money.

First, other regulations aimed at improving alignment with end-investor goals, such as the 2012 UK Retail Distribution Review, have been taking effect. Investment managers and advisers have been right to focus on implementation of these high-profile regulations.

Second, the opaque nature of the payment mechanism made it hard to see the costs involved. Limited awareness even of the existence of research commissions is perhaps understandable given that few buy-side firms presented research costs at all.

Third, low awareness of the mechanics of research commissions provided media and the public with limited understanding of the issues.

The UK FCA’s 2013 Thematic Review changed this, and specialists within the financial press now keenly study the issue on both sides of the Atlantic and elsewhere.

Fourth, the 2008 financial crisis and resulting gyrations in equity markets required asset owners to focus on other priorities in order to survive long enough to consider this issue of longer-term consequence.

It remains unclear whether asset owners have a fiduciary responsibility to monitor their managers’ research spending and its relationship to fund returns. CFA members will recognise their responsibility to meet CFA soft dollar standards which provide guidance on how to use client brokerage ethically. The standards recognise the possible conflict of interest between the buy-side firm and its clients that arises from the opportunity for an investment management firm to offset some fixed costs through the use of services paid for via client commission. The standards seek to require members to manage that conflict appropriately through their own actions and by providing clients with the information that they might need to monitor their managers’ behaviour.

Note that fund managers can buy whatever research they want if they pay with their own money and asset owners should also consider procurement in their evaluation.

**WHAT CREATES THE BEST OUTCOME FOR INVESTORS?**

Is the lowest possible research cost in the best interest of the asset owner if it results in sub-optimal research provision and investment decision making? We believe that efficient use of research spending is the key. Asset managers should be expected to align the research budget with the investment strategy, investable universe and expected returns at the fund level.

As always, there are likely to be costs to regulation as well as benefits. Close relationships with sell-side analysts provided fund managers with tailored information, thus allowing the best shot at market outperformance, and this is entirely in the end-investor’s interests. Cross-subsidies between business units at banks provided a model that allowed fund managers to benefit indirectly from expertise and services beyond research. Investment banks struggled to limit the dissemination of research and much was often available to smaller fund managers, thus helping them to compete against larger firms. Given the social complexity and economic dynamics of the interface between buy-side and sell-side experts, it seems unlikely that more rigid regulation could not come without costs to the end-investor. This key point is frequently lost in the debate.

The original MiFID II proposal to require asset owners to approve their asset manager’s proposed research budgets would directly involve asset owners in the research funding discussion. UK pension trustees are frequently not investment professionals and therefore not usually qualified to judge complex and variable research budget proposals from widely differing investment strategies. They face the following questions: Is the same research budget appropriate for a distressed debt fund and a highly leveraged emerging market equity hedge fund? What is the ‘right’ price for research? What is the relationship between research budget spending and end-investor’s outcome (expected returns)?

It is likely that multiple answers will emerge. This need not be a poor outcome. Different firms representing different sets of asset owners should be encouraged to articulate the best practice to suit their end-investors. The UK National Association of Pension Funds has recognised the need for a principle-based approach, balancing the appropriateness and alignment of the research budget with the underlying investment strategy and expected returns.
HOW MIGHT ASSET OWNERS EFFECT CHANGE?

While acknowledging that there are different ways to succeed in aligning research procurement with client interests, we identify several ways that influential asset owners, such as sovereign wealth funds and pension plans, could effect change.

First, fiduciary capitalists will lead the efforts to compare research costs to investment goals and will demand information be presented in their preferred format and frequency. Asset managers will then be required to provide such information in the course of client reporting and when competing for mandates. International regulatory co-ordination on research procurement has typically been limited. Major asset owners have the power to improve the practices of investment management groups worldwide. This could avoid damage to competition between geographic investment management hubs due to regulatory arbitrage. Although MiFID II provides the opportunity of consistent regulation across one continent, therefore reducing the risk of regulatory arbitrage, a relatively stricter interpretation of the delegated acts in some European markets could discourage fund managers from operating in there. Reduced competition has also been argued to result in a loss of high quality fund management jobs in countries where research payments are most restricted.

The likelihood of differing national interpretations of the same MiFID II text presents a key risk to the entire process if it creates an un-level playing field across Europe. If all or any part of Europe bans the use of commission for research, this will represent a significant trans-Atlantic non-tariff barrier in international capital flows. At the time of writing, European regulators have stepped back from such draconian plans. The use of commission for research is enshrined in 28(e) of the Securities and Exchange Act of 1934. This venerable Federal statute is unlikely to change.

Second, asset owners need to be aware that unbundling could lead to potential concentration in the investment management industry. Bundled commissions supported smaller buy-side firms: effectively they were subsidised by larger buy-side competitors. Although undesirable in terms of fiduciary responsibility, this acted to level the playing field. Start-up investment management firms would often seek access to investment bank research in their early days while operating on seed funds. Unbundling therefore presents a higher barrier to entry to new fund managers and may encourage a further shift in power to large investment management groups.

Third, asset owners should demand that investment managers adopt the following practices:

1. Research budgets should be set based on an independent review rather than by portfolio managers. Aggregate research commissions should require board approval. Ongoing internal consistency checks under the oversight of the investment management firm’s Chief Financial Officer or equivalent should be reviewed in an annual audit.

2. The firm’s compliance team, not the portfolio management team, should manage the process. Portfolio managers may, however, shape the design of the policy within their firm.

3. Appropriate records of research consumption should be maintained to the highest regulatory requirements globally. In most firms this will require improved accounting practices.

4. Provide clear and consistent feedback to research providers as to what products/services are valued.

In time, research budgets should be monitored against quantitative benchmarks. Such benchmarks are likely to emerge and become available by the end of the decade. In the interim a clear comparison with previous years will allow asset-owners to evaluate research efficiency. MiFID II delegated acts, released in April 2016, can be interpreted to include fixed-income research where commission is not paid and therefore has been sheltered from regulation on research payment. Moves to bring fixed income markets into line will present a major change for many bond fund and multi-asset managers who were not able to use CSAs but will be required to initiate RPAs as they move to price research. In particular, multi-asset managers may be asked to present research costs for equities, bonds and other types of investments. We believe that asset owners may be more effective than regulators in non-commission markets.

CONCLUSION

Research procurement has seen a murky past. Ten years after the 2006 introduction of CSAs in major equity markets, transparency is improving. Investment managers are moving towards better practices.

Significant improvements in the first half of this decade largely stem from the responses of research consumers and producers to UK regulatory change. Such practice has been mirrored around the world to varying degrees. The spotlight has been directed to research procurement, and as a result the topic has moved up significantly on the ‘to do’ list for those managing investment firms. The issue is here to stay. End investors stand to benefit.

Yet fiduciary capitalists appear to remain largely silent on the issue. Like other participants, asset owners will have been watching the interplay between regulators, government agencies, firms and bodies representing industries and professionals in the lead-up to MiFID II. The interpretation by regulators in Europe and other important markets and the response from firms developing global policies will take longer to emerge. In the coming years, from 2017 to 2018, research valuation information will become more available for asset owners who will then aggregate and compare research costs to custodial and other costs. More informed asset owners will become more vocal and will perform an important monitoring function.

In this paper we provide recommendations to assist them to make this important change. We expect the current level of scrutiny of research procurement will reach a higher bar. Compliance, transparency and fiduciary responsibility is likely to increase, and compliance departments the world over will be busy ahead of MiFID II taking effect, which is widely expected to be during 2018.

The impact has spread well beyond the UK. The CSA mechanism allowed independent research providers to enter the market. Buy-side research budgets are expected to fall as poorly justified elements of bundled research are removed. However, despite the challenges to research budgets, there is sufficient commercial demand for independent research to fuel innovation both directly and indirectly.

Rather than acting to minimise the cost of research, we recommend aligning the research budget with the investment strategy, universe and expected returns at the fund level.

Asset managers have fiduciary responsibility to act in their clients’ interests. When paying for research there should be a clear demonstration of the expected value of that research in obtaining the investors’ goals. Research consumers and producers have been vocal in providing feedback to proposed regulations. Asset owners, in contrast, have been watching quietly. Given that they may have a fiduciary responsibility to evaluate research spending, we expect this group will be the next to take action to further improve the lot of the active investor. Most likely this shift will occur once MiFID II has been integrated into member state regulations. Fiduciary capitalists will then use their power to improve alignment of investment manager action with end-investor goals.
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Alistair Haig ACSI worked in buy-side and sell-side investment research for 15 years before joining the University of Edinburgh Business School in 2012. All his academic projects are motivated by live practitioner questions, and his primary focus is on how professional investors choose to procure information from external sources, such as sell-side and independent research firms. This has become known as the market for investment research. He teaches financial markets and applications of finance on MA, MSc and executive education programmes, is an active member of several professional bodies and takes a long-term approach to investing.

Neil Scarth has held a wide range of roles in asset management and investment banking in Europe and North America over the last 25 years, ranging from running equity businesses at global banks to launching and managing various asset management products. Neil has comprehensive knowledge of the strategic and competitive framework that governs the inter-relationships between plan sponsors, asset managers and investment banks. Neil was a member of the UK Investment Management Association’s Research Review Advisory Panel, which helped craft the association’s response to the FCA on research commissions. Neil holds an MA from the University of Southern California and a BA from Carleton University.

Haig and Scarth will be speaking about their research at CISI events in Edinburgh and London in autumn this year. See cisi.org for details.

POCA – UP TO THE CHALLENGE OF ORGANISED CRIME?

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In a previous contribution to the Review of Financial Markets, Kenneth Murray argued that money laundering offences are not being used against organised crime in the manner originally envisaged. “The concept of predicate offence often persists in the discourse yet is not a requirement of the act. It distorts our understanding of what money laundering is and how it can be prosecuted.” The case continues.

The essential question is whether the Proceeds of Crime Act 2002 (POCA) is up to the challenge of dealing with the realities of the crime as it is conducted, given the conceptual influence of the ‘placement-layering-integration’ model read into its construction and the atavistic influence of ‘predicate offence’ in terms of how it continues to be interpreted. The UK legislation was designed to be sufficiently flexible in its drafting to offer ways of meeting the related challenges, but perhaps the question is whether it is being fully allowed to in practice.

POCA has been described by one eminent QC as “draconian and manifestly unjust” in respect of its confiscation provisions and some judicial interpretations of it in recorded cases appear to have been more concerned to limit the scope of its application in ways that can be considered to affect its suitability and ability to tackle the money laundering crimes it was enacted to tackle.

JUDGMENTS

The judgment in R v NW, for example, effectively sought to re-establish the eminence of predicate offence, in apparent contradiction of the spirit of the Crown Prosecution Service (CPS) guidance: “we do not consider that Parliament can have intended a state of affairs in which, in any given circumstance, no particulars whatever need be given or proved of a cardinal element in the case, namely the criminal conduct relied on.” Although the subsequent 2010 judgment in R v Anwoir subsequently affirmed the principle of irresistible inference in proving the necessary criminality, this is not a development that has been welcomed by everyone in legal circles, with R v NW still being defended as ‘good law’.

The ability to prove that money is criminal through circumstantial evidence implies acceptance that the necessary tests can be conveyed by the way the money or property is treated. It is difficult to see how convictions could be obtained if this were not the case. It is how this is ability is interpreted by the courts, however, that determines perceptions of how it can be applied.

A key judgment in this area was given in the Geary case, and the findings of this case have been further endorsed recently in the case of R v GH. These judgments say that s328 offences relating to arrangements have to apply to property that can be identified as criminal at the time
the arrangement begins to operate on it: “In our view the natural and ordinary meaning of section 328(1) is that the arrangement to which it refers must be one which relates to property which is criminal property at the time when the arrangement begins to operate on it. To say that it extends to property which was originally legitimate but became criminal only as a result of carrying out the arrangement is to stretch the language of the section beyond its proper limits.” 7

R v GH clarified the issue as follows: “Criminal property for the purposes of sections 327, 328 and 329 means property obtained as a result of or in connection with criminal activity separate from that which is the subject of the charge itself.” 8

So the property must be criminal at the outset. How can that be proved? ‘Criminal property’ is defined at s340 as follows: “a) it constitutes a person’s benefit from criminal conduct or it represents such a benefit (in whole or in part and whether directly or indirectly), and b) the alleged offender knows or suspects that it constitutes or represents such a benefit.” 9

When, according to POCA, does the property become criminal in terms of proof?

Because criminal property is defined in the Act at s340 in terms of knowledge, it could be construed that what the Geary and GH judgments are saying is that there is a requirement to prove the accused knew the property was criminal when he first came into contact with it. A difficulty arises, however, if this proposition can be interpreted as meaning that the method of treatment by the accused cannot be used as a basis for determining his knowledge of its criminality prior to receiving it.

When, according to POCA, does the property become criminal in terms of proof? Criminal awareness is clearly connected to the nature of the arrangements the accused participates in. That awareness may well develop and become clear when he is able to properly appraise the true nature of these arrangements. It is not clear from the text of the relevant POCA provisions that this has to be at the start of his involvement in these arrangements. This is a matter of considerable practical significance since it is often the case that proof of awareness in these circumstances is established by the manner in which the accused treats the relevant funds.

The implication of the Geary and GH judgments is that there are two distinct parts of the criminal property definition that have to be separately proven and that the criminality of the property has to be proven at the outset of the arrangement starting to act on it. In other words, it appears to take away the possibility of establishing cases where the relevant criminal knowledge is revealed by means of the way in which the money is treated.

The R v GH judgment appears to confirm this through its discussion of the drafting matter at the heart of this issue as follows: “As a matter of strict English, the way in which the section has been drafted may be criticised for condensing the separate ingredients of actus reus [guilty act] and mens rea [guilty mind] into one. But it places no undue strain on the language to read the section as providing that a person commits an offence if a) he enters into or becomes concerned in an arrangement (relating to criminal property), and b) he knows or suspects that it does so.” 10

The judgment then follows this with a sentence which has profound significance, notwithstanding its almost throwaway nature: “It has to be sensibly read in that way or else a party might be guilty by reason of having the necessary mens rea even if it transpired that the property was not criminal.” 11

What this last sentence might imply is that a catch all defence is available to all organised crime groups using money laundering schemes which show the most basic levels of sophistication. No matter how compelling the evidence might be relating to the accused’s treatment of the money concerned, the lack of any direct evidence proving its criminality at the outset of his engagement with it means he cannot be found guilty – in case it turns out that it isn’t.

It is not easy to reconcile this with the ‘irresistible inference’ doctrine unless it can be subsequently made clear by the courts that actions of deceit in treatment can qualify as evidence of criminality in cases where, as is often going to be the case, there is a lack of evidence of criminal source.

In Scotland, in the wake of a judgment (in the Sarwar case12) which has been interpreted as emphasising the need to prove all the constituent parts of the offence, prosecutors in practice are following a construction which relies on the relevant proof requirements being an objective test (the criminality) and the subjective test (knowledge of the criminality). Again, if it is to be insisted that these are two separate tests and that evidence of treatment cannot simultaneously meet both tests then, as far as most forms of organised crime money laundering encountered in practice is concerned, the legislation might be regarded as simply not fit for purpose.

The Handley case referred to above indicates that it is possible to achieve ‘irresistible inference’ convictions in Scotland on the basis of evidence that relates to how money is treated, but that was a case settled by plea. If legal agents acting for money launderers are encouraged to consider that de facto proof of predicate offence is a requirement for successful prosecution, then the plea bargaining dynamic is materially altered. We will have reached a position where the signals taken from judicial interpretation of the legislation have arguably gone some way to neutering its effectiveness, certainly in the context of how it applies to the crime of money laundering as perpetrated by organised crime groups.

THE GROWING ROLE OF TRADE BASED MONEY LAUNDERING

Probably the principal means by which serious money is laundered across the world is trade based money laundering (TBML). This is a method which essentially depends for its successful execution on the creation of self-contained modules in the money laundering process, which make prosecution extremely difficult unless the method of treatment can be used as the principal source of founding evidence.

What is TBML? A shorthand way to getting to the essence of it is by considering an invoice, or whatever paperwork provides the creation of self-contained modules in the money laundering process, which make prosecution extremely difficult unless the method of treatment can be used as the principal source of founding evidence.


7. POCA s 328 (1).
9. POCA s 340 (3).

THE GROWING ROLE OF TRADE BASED MONEY LAUNDERING

Probably the principal means by which serious money is laundered across the world is trade based money laundering (TBML). This is a method which essentially depends for its successful execution on the creation of self-contained modules in the money laundering process, which make prosecution extremely difficult unless the method of treatment can be used as the principal source of founding evidence.

What is TBML? A shorthand way to getting to the essence of it is by considering an invoice, or whatever paperwork provides the reason for funds to be transferred from one place to another, to be a passport. TBML essentially involves the use of false passports.
CONSIDER THE FOLLOWING EXAMPLE:

The criminal cash travels from the foreign company to the UK company under the false passport of the invoice, which overvalues the price of the goods actually transported. This additional value can then be realised through normal trading at normal prices. The proceeds of this legitimate trade can then be distributed by way of dividends or loans or other transfers to a vehicle in the UK, which in turn enables access to the laundered funds – or more precisely funds representing the laundered funds – in the UK. The same process works in the field of securities and investments.

There are many variations on this theme. For example, it may be that the quantities of the commodity are falsified rather than the values relating to it. The key defining characteristic is the existence of some form of deceit in the passport. Any evidence of a falsified passport in the context of commercial trading is, or at least ought to be considered, strong prima facie evidence of a TBML mechanism being in place.

The global significance of TBML can be grasped from a 2015 Global Financial Integrity report\(^\text{13}\) which estimated that as much as 80% of illicit financial flows from developing countries were accomplished through TBML – increasing from more than $200bn in 2002 to more than $600bn in 2011. PwC consider these figures “represent the tip of the iceberg in showing TBML’s growing scale.”\(^\text{14}\)

TBML represents a challenge for Law Enforcement and it is not clear it has the resources or expertise to adequately deal with it. The duty of law enforcement in this context clearly entails an ability to understand the manner in which the crime is perpetrated and develop the capability to develop prosecutions using relevant evidence. It is surely not enough to be in the vanguard of proceedings of crime initiatives or to demonstrate public hostility to money laundering as a crime if it turns out the channel through which most money is laundered, TBML, is not capable of being policed. An obvious consequence of this is that the more effective you are at clamping down on the obvious channels, the more TBML will dominate as the route of choice for launderers.

There is indeed evidence that the incidence of TBML may be positively correlated to the effectiveness of orthodox AML controls: countries which have strict anti-money laundering legislation experience more trade related money laundering.\(^\text{15}\) This has led to claims by the accountancy profession – no doubt identifying a new source of fee income – that increasing attention is being given by regulators to TBML in their discussions with financial regulators, and PwC considers it is “a matter of time” before this results in “concrete action”.\(^\text{16}\)

The tendency with such intractable problems is to reach for an all-encompassing solution. In the case of TBML this is unlikely to exist, but the extent of the challenge is not a justification for ignoring it. The challenge might be more usefully considered in terms of how the response to TBML could be improved given the current tool box – in terms of legislation, regulation and law enforcement response – so that any major decisions regarding future regulation can at least be made on a more secure and knowledgeable foundation. This is not just a matter of improving the empirical data. It is a question of trying to better understand the nature of the challenge and to develop better approaches to dealing with the relevant criminality.

How do we go about this challenge? Simon Mackenzie and Niall Hamilton-Smith of the Scottish Centre for Crime and Justice Research, University of Glasgow, emphasised the need to understand context: “The point is simply that unless we know the context within which these targets operate, then we are working ‘in the dark’. So either we need to generate this contextual knowledge in order to make sense of current targets (which is a large and serious research undertaking) or we need to set different targets that make sense within the knowledge we currently have (or can reasonably be expected to get) about the real incidence and impact of organised crime.”\(^\text{17}\)

In a paper for the International Drug Policy Consortium in September 2013,\(^\text{18}\) Professor Mike Levy of Cardiff University added to the voices of academia calling for better data, but he also made a number of other points in the context of drug law enforcement and financial investigation strategies, which pointed to a more nuanced appreciation of the key issues on the ground that require to be considered in more depth before any proper assessment of the efficacy of this legislation can safely be made. The paper included the following:

- The term money laundering may conjure up too vague and unspecified an image to fit the reality. ‘Crime money management’ may be a productive alternative.
- Financial investigation is often mistakenly seen only in the context of proceeds confiscation rather than in revealing forensically the financial relationships in drugs networks.
- Financial investigators – whether police, civilians or trained accountants – need to be embedded with operational and intelligence units, so that they are brought in early enough to help the investigation as well as to take away proceeds of crime.
- Criminal finance analysis and UK post-conviction Financial Reporting Orders can be used fruitfully to target the most harmful networks – local, national and international – but this needs to be mainstreamed.
- Financial investigation and proceeds confiscation/recovery can impact upon public reassurance and the behaviour of financial intermediaries as well as drug offenders – but these goals need to be separated out and evaluated, not just asserted.

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These points also chime with some of the concluding points made by Ian Davidson at a 2014 workshop at Sussex University, paraphrased as follows:

- The strategic objectives in tackling the criminal finances of organised crime groups are currently unclear.
- There is a need to move away from law enforcement activity in this area being based primarily on opportunity rather than intelligence.
- There needs to be a better understanding of how Proceeds of Crime activity can drive operational activity and impact. If it doesn't impact on organised crime, what is the point of having it?

An initiative has been developed within Police Scotland which has the intention of meeting some of these challenges in this area: Project Jackal.

The specific challenge addressed by Project Jackal is to translate a conceptual framework based on business strategy analysis to a practical programme capable of being absorbed into practical models of policing and deliver tangible results.

In the field of organised crime, the principal theme of law enforcement models is that they are intelligence-led. The nature of the intelligence to hand is accordingly a key determinant of what is done. If the intelligence requirements set emphasise the ‘hands-on’ aspects of drug trafficking (where the evidence indicates direct or traceable contact between the physical commodity and the accused), then it is coverage of that side of the business that will be most extensively covered in terms of intelligence capture. The training of intelligence sourcing personnel often reflects a background in an anti-drug trafficking enforcement with substantial expertise in that field built up and absorbed into the knowledge fabric of the respective law enforcement bodies. That body of knowledge is commonly strong on the side of the transaction which relates to the transfer of commodity and weak on the part of the transaction which relates to the money.

Project Jackal seeks to broaden the range of the relevant officers’ interest from: (i) the drugs; to (ii) the money; to (iii) the business processes. The effort required encompasses a need to broaden education, encourage new skill development, recruit the right specialist support, and drive cultural change. The essential proposition is that a modern law enforcement operation cannot meet the challenges of organised crime without a willingness and ability to develop an understanding of organised crime as a business. The question is how it can be done. The method to be described below is clearly not the only way it can be done, but it is a way that is currently being tested in practice by Police Scotland.

Project Jackal was launched in June 2014 primarily as a means to encourage the capture of intelligence relating to organised crime group (OCG) businesses and finances. The two principal areas of focus were cash flows and business networks. A toolkit was designed based around simple questions with the aim of encouraging relevant police personnel to develop an awareness of these factors and record the intelligence that improved awareness in intelligence logs. In terms of generating intelligence logs, the early signs have been encouraging.

The impact on organised crime of improving understanding of business structures will hinge upon developing workable methods for using that intelligence in ways that can translate into tangible results in terms of convictions, disruptions and asset recoveries.

The basis used for the transition from a raw collection of business oriented intelligence to an effective analysis of the strengths and weaknesses of an OCG or network is a matrix arrangement adapted from that developed by Osterwalder and Pigneur in their manual for generating business models, *Business model generation: a handbook for visionaries, game changers, and challengers*. The attraction of the approach developed in the book is that it uses a matrix concept which, in the authors’ words, is “simple, relevant and intuitively understandable, while not oversimplifying the complexities of how enterprises function”.

This is a prescription that seems ideally suited to the law enforcement community in respect of the challenge of tackling organised crime: a construction that everyone can relate to and contribute to, yet capable of grasping and making sense of the relevant complexities.

Such a model offers possibilities of developing a language that can be shared across the many platforms in terms of agencies, nationalities and territories relevant to the realities of organised crime business. It can in short be applied to any situation, any collection of organised crime groups forming a network, any organised crime process that constitutes a profit stream. Whatever the local differences or variations in custom and method, such a model will be able to accommodate them in the field of organised crime, just as the original conception of the model by Osterwalder and Pigneur was designed to accommodate any kind of legitimate business. In their words: “We believe a business model can best be described through nine basic building blocks that show the logic of how a company intends to make money. The nine blocks cover the four main areas of a business: customers, offers, infrastructure, and financial viability. The business model is like a blueprint for a strategy to be implemented through organisational structures, processes and systems.”

The matrix arrangement used by Osterwalder and Pigneur to group these factors is shown on the next page, adapted to make it more relevant to organised crime.

The key differences from the Osterwalder and Pigneur matrix is that along the bottom row, ‘Cash resources’ is substituted for ‘Cost structure’ and ‘Revenue spend’ is substituted for ‘Revenue streams’. This is in order to match up the idea of cash flow through an organised crime group, network or process, with the intelligence capture efforts relating to cash described above.

The middle box seeks to gather together the principal themes and narratives emerging from appraisal of the contents of the boxes to the left and to the right of it under the heading In this box the key strengths and weaknesses of a group, network or process are identified in order to suggest options and opportunities for suitable exploitation by law enforcement and partner agencies.

The other boxes remain as Osterwalder and Pigneur designed them for legitimate businesses. The main body of the matrix divides into a left-right division between product supply processes on the left and customer facing processes on the right.

The matrix can initially be used as a sorting box for relevant intelligence and analysed in terms of the principal characteristics associated with each box heading. For example, in respect of a straightforward drug trafficking process involving an OCG, the partners required to establish

the business are in the far left box under KP (key partners); the key activities of the group, such as import and distribution, are under KA (key activities); and the supply sources of the drugs are under KR (key resources). On the right hand side, the methods used to exercise discipline and maintain market share are grouped under CR (customer relations); the warehousing and distribution networks accessed and used to generate the relevant sales revenues are grouped under CC (customer channels); and the various end markets served are grouped under CS (customer segments).

The box that requires a degree of analytical thought is VA (vulnerabilities & actions). The challenge here is to bring together the information contained within the matrix in such a way that explains one basic thing: why is this group/network/process profitable? What are the distinctive capabilities that make it successful, or at least help it to survive? Assessment of strengths goes hand in hand with assessment of weaknesses, and the action driver of this approach derives from these weaknesses being identified as vulnerabilities that can be exploited in terms of options and opportunities for convictions, disruptions and asset recoveries. In essence, every identified vulnerability should obligate the generation of actions to exploit these options and opportunities.

A guide to generating meaningful answers in terms of distinctive capabilities and vulnerabilities is provided in terms of the questions posed in the respective matrix segments above. The questions are not necessarily definitive and of course may vary in respect of contexts – one of the key benefits of this approach being flexibility. The essential proposition, however, is that there is no organised crime group, no organised crime network, and no organised crime process that cannot be meaningfully subjected to this analysis.

A further advantage of this approach is that it ought to drive continuous improvement in the quality and quantity of relevant business intelligence sourced on organised crime across the EU territories. The matrix offers a natural collaborative platform and the use of it will encourage the upgrading of intelligence gathering efforts through the identification of conspicuous systemic gaps and the competitive effects within the EU law enforcement community of natural peer pressure.

But what of the products? A better understanding of business process enables improved capture of intelligence relevant to the formation of money laundering cases and legislation designed to punish direction and involvement in organised crime. A better understanding of key supply and distribution networks enables targeted programmes of disruption to be constructed in ways that can more accurately predict punitive effect and displacement fallout. There will be a direct positive impact on the amount and value of criminal assets and property that come within reach of the various criminal and civil asset recovery mechanisms. There is a basis for more effective integration of anti-OCG activity with tax enforcement measures both within and across borders. There is finally the ability to generate narratives that can influence participants’ and enablers’ perspectives of the risks versus the rewards of getting involved in organised crime. In this sphere, credibility of response is of fundamental importance.

Project Jackal is in its early days. It is anticipated it will improve the capabilities of law enforcement in establishing and developing money laundering cases against organised crime groups and develop a better understanding of the processes and structures they use. It emphasises that getting a better grip on how money is handled, channelled and used by organised crime groups is not an optional extra for law enforcement and it acknowledges that a commonly and dangerously underestimated feature of criminal cash is the acute and far reaching harm its deployment brings to people, jobs, markets and communities.

This is a subject that can attract cynical responses, but the challenges faced by law enforcement in terms of money laundering might echo those successfully overcome in respect of insider dealing – another money based offence widely criticised as being impractical and almost prohibitively difficult to prosecute. The shock of the 2008 financial crisis proved the spark that created the will to take action to turn around a hitherto dismal and routinely derided prosecution record. The first criminal sentences were in 2009 and a number of prosecutions and heavy fines have followed since. The *Daily Telegraph* reported last year that the incidence of insider trading had “plummeted” since the financial crisis. The FCA is reported in the same piece as claiming that nothing proved so effective in achieving this result as “the willingness and ability to prosecute”.

CONCLUSION

There is a responsibility on law enforcement to up its game in terms of improving intelligence capture and how this intelligence is used with a view to better understanding the methods used by organised crime groups to launder their money and manage their economic affairs. That will provide dividends in terms of placement evidence, which might enable classic predicate offence type charges, but it will also provide the potential to posit evidence of schemes in such a way that enables the prosecution of money laundering schemes in the contexts in which they actually exist, which feature the disconnects that make reliance on proving criminality through provenance, rather than treatment, so difficult.

POCA was designed in such a way to help meet that challenge. If interpretations placed on it by the courts restrict that, then perhaps there is a case for revisiting the legislation. Ultimately, we may need to redefine perceptions of what money laundering is and what it looks like. As Professor Michael Levi has suggested: “The term ‘money laundering’ may conjure up too vague and unspecified an image to fit the reality.”

In the meantime, however, the establishment of a consensus which accepts a principle of culpability arising from evidence of manner of treatment – such as the use of ‘fake passports’ in the form of false invoicing, fake loans arrangements or other means of discovered subterfuge – is a long overdue and necessary development to our approach to dealing with and containing this pervasive, distinctive and deeply serious crime.

banks in the sector. The pension fund recognises that it's not the only shareholder meeting to discuss conduct and culture, but its approach of wanting to see the whole industry succeed is different.

Positive change was further encouraged by feeding back results in the form of a report to the BSB as well as each bank. The pension fund believes that sharing good practice is good for UK financial services and the investments that members have with it.

The study found that conduct and culture in 2014 and 2015 encompassed six different behavioural 'domains'. Each of these has its own findings. Expert interviewees thought these domains were key to improving conduct and culture. The domains are:

1. Simplification of the business
2. Corporate purpose
3. Organisational culture
4. Focus and engagement by the chair of the board
5. Staff in the business
6. Customer experience

Baselines were developed to capture where banks are in relation to these six domains. Explanations were derived for why banks were where they were in relation to each baseline. Pressure was put on those below the baseline, and particularly in the lower quartile, to improve conduct and culture. The pension fund also gathered a large number of metrics used to measure conduct and culture change, with the aim of assessing their value relevance.

Of the six domains identified, corporate purpose, organisational culture, and staff in the business, were the heart of conduct and culture. Two domains, simplification and customer experience, were more peripheral. The other domain, focus and engagement by the chair of the board, was between the two.

A second overall finding is that greater improvement in culture was made when not set from the top. This finding contrasts with the recommendation of the UK Corporate Governance Code that a key role for the board is to establish the culture, values and ethics by setting the correct 'tone from the top'. A board can set values, mission, and purpose, but people together constitute the culture. Culture is an outcome. Culture is interpersonal, and embedded by people doing banking day-by-day, which comes from a myriad of interrelationships and interactions at a grassroots level. To get to the heart of culture and provide the shift that banks and regulators desire, much more effort needs to be expended at the grassroots level where interactions, intent and action occur. Culture change was more innovative and dynamic when strategy and implementation was 'driven' from within the business and not from the top. The vital role for the chair and the whole board is focus, engagement, appraisal, and trained questions about the culture programme designed and delivered by the department most apt to handle it. From a culture perspective, the board should not set the tone from the top. As a myriad of people interactions constitute culture, we are in danger of reductionism to believe that a board can simply do this. Culture is a slow-moving constitution and the evidence from this study is one of years of effort for slight improvement.

The third overall finding is that conduct and culture was highly metricised, but there are contradictions and ambiguities with many of the metrics. The contradictions and ambiguities present in many of the metrics posed difficulties about which to give attention to, and how. For example, one typical metric was the number of personal conduct cases per 1,000 staff. Is a falling number of personal conduct cases good, as this could indicate improving conduct, or bad, as this could indicate a culture in which situations are not being dealt with at an early stage?

Banks making the largest improvements in conduct and culture were those grappling most with, and solving, the ambiguities with metrics. For example, less ambiguous whistleblowing metrics were based on service, and included availability of different channels to whistleblow through, response times, resolution, and feedback from users. Metrics and measures represented a key source of management information about conduct and culture.

The study makes the following three contributions to knowledge in the subject area:

First, the paper reports new and recent research into how small groups of people – officers, directors, and managers – are designing and delivering conduct and culture programmes at UK listed banks. The project, spanning two whole years between 2014 and 2015, represents a rare insight into an industry-wide attempt to improve intent, motives, action, and outcomes.

Second, how conduct and culture is done is far more critical to performance than the structure that surrounds it. Structure can help improve conduct and culture, but is not nearly enough because conduct and culture is about people in the workplace, their actions, and interactions. Far more critical to performance than structure is the ‘doing’ of conduct and culture. ‘Doing’ conduct and culture rests on the right people giving attention to how other people will of their own accord behave and act in line with a central purpose. When a board put the department most apt to handle the design and delivery of conduct and culture in charge, there was more focus on the grassroots level of the business and more progress. When boards 'set the tone from the top' they tended to focus on structure and made less progress. This contribution helps to explain the second overall finding that from a conduct and culture perspective, banks perform better when the board doesn't set culture.

Third, the research gives a picture of bank conduct and culture just as the BSB was about to start work. The BSB has used the results to establish an initial benchmark on conduct and culture. Since the research took place just prior to the creation of the UK BSB, the effectiveness of the BSB itself could be investigated by looking at how much movement there has been from the snapshot taken by this study and a second snapshot taken in the future. This presents an opportunity to determine the effectiveness of a new type of government encouraged, industry-led but non-law making regulator.

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From 1993 to 2000 he worked at Kleinwort Benson Investment Management as an equity fund manager of actively managed international and emerging market mutual and pension fund portfolios. He has extensive experience of working with investment institutions and with government departmental and non-departmental bodies, and as part of his work with NEST, he has produced with his colleague Diandra Soobiah, Head of Responsible Investment at NEST, a fascinating and groundbreaking analysis of culture and conduct in UK banks, of which the article above is an excerpt.

The full paper is available at cisi.org/rofm, and Dr Cox will be discussing the outcomes of the research at a special seminar in London on Wednesday 13 July, which will subsequently be available on CISI TV. Details at cisi.org.