FINANCIAL CRIME: ENFORCEMENT

HOW TO AVOID AUSTRAC'S FEARED LITIGATION TEAM

A Regulatory Intelligence interview with:

Sonja Marsic, executive lawyer, Australian Government Solicitor

Neil Jeans, principal consultant and founder, Initialism

the answer company™
THOMSON REUTERS®

INTERVIEW

By Nathan Lynch, Regulatory Intelligence

The recent ACAMS Australia conference gave financial crime practitioners an unprecedented level of detail about the strategic decision-making and policy issues behind the record A$1.3 billion Westpac anti-money laundering litigation.

Two high-profile speakers at the event included Sonja Marsic, senior executive lawyer with the Australian Government Solicitor (AGS), and financial crime expert Neil Jeans, who leads Initialism, a specialist anti-money laundering and counter-terrorism financing (AML/CTF) consultancy.

Marsic represented the Australian Transaction Reports and Analysis Centre (AUSTRAC) in the Tabcorp, Commonwealth Bank (CBA) and Westpac civil enforcement actions. Jeans was the expert witness for AUSTRAC in the CBA and Westpac cases, which are still by far the biggest civil enforcements in Australian corporate history.

After the conference, Marsic and Jeans spoke about the key lessons from these enforcement actions and the secrets to staying out of AUSTRAC's crosshairs.

What role does the risk-based approach play in achieving AML/CTF compliance?

Sonja Marsic: The risk-based approach to AML/CTF regulation gives a reporting entity a lot of flexibility as to its own risk appetite and as to how risks will be managed.

The flipside to this is that there's no prescriptive checklist set out in the law to tell reporting entities exactly what to do. So, this puts the onus on reporting entities to demonstrate that their AML/CTF program, by design, is capable of appropriately identifying, mitigating and managing the ML/TF risks that are reasonably faced.

Neil Jeans: The identification, mitigation and management of ML/TF risk is fundamental to a reporting entity being able to demonstrate its AML/CTF program is compliant with the AML/CTF Rules. With the notable exception of reporting obligations, the use of a risk-based approach is required for many requirements set out in the Rules.

The application of a risk-based approach allows a reporting entity to adjust, and "right-size", their systems and controls. However, this must be based on a clear understanding of the ML/TF risks it faces. And therein lies the rub: if a reporting entity's ML/TF risk assessment, including the methodology that underpins it, is inadequate there is an increased likelihood that the systems and controls established as part of the AML/CTF program are likely to be inappropriately designed — or operationally ineffective — to mitigate and manage the ML/TF risk. That will likely result in non-compliance with the AML/CTF Rules.

The establishment of an appropriate ML/TF risk assessment is a foundational AML/CTF compliance activity, which reporting entities should focus significant effort upon, and pay particular attention to, getting right.

How important is it to have appropriate governance and oversight mechanisms in place — from both a risk and compliance perspective?

Sonja Marsic: Appropriate frameworks for governance and oversight would be number one on my list.

Governance and oversight are at the heart of the risk-based approach. AML/CTF is so much more than a checklist, an SMR or a 100-point check. By force of legislation, businesses are required to take responsibility for their own risks and to take steps to deter and manage those risks.

Boards and senior management are responsible for setting risk appetites and for putting controls in place to ensure that ongoing risks are managed within that appetite. This can't be done without active engagement by boards and senior management. The Part A program is intended to be the framework through which this active engagement occurs.

Obviously, boards and senior management aren't expected to be at the coalface and across all interactions with customers and across all business processes. But they do need to satisfy themselves that current risks are understood, that controls are capable of managing risk within their appetite and that appropriate reporting mechanisms are in place to give them assurance that those controls are operating as intended.

A regulator can tell a lot about risk culture from what does or doesn't get reported up the line and from what is or isn't discussed in board or senior management minutes.

I would expect to see appropriate governance and oversight processes clearly set out in the Part A program.

Neil Jeans: Boards and senior management must ask themselves: are we receiving sufficient information about the adequacy of our AML/CTF program? This includes understanding if it is operating effectively, and can only be achieved through the provision of regular and comprehensive information about the AML/CTF program from the business, as well as the AML/CTF compliance function.

However, that's the easy bit, relatively speaking. Increasingly, boards and senior management must be able to demonstrate they are not simply passive observers of AML/CTF compliance and are actively challenging the information they are receiving. This creates a significant issue for boards and senior management because they are not, and nor are they expected to be, AML/CTF experts.

Boards and senior management need to ask themselves: how can we get an objective view of the adequacy of our AML/CTF compliance arrangements?

Against the backdrop of AUSTRAC's enforcement action, there has been an increased demand for independent reviews by boards and senior management. However, these are only infrequent snapshots, and some boards have also appointed external advisers. This may not be appropriate for all reporting entities, but it is an approach that's being adopted by some of the larger and more complex reporting entities to provide the board with an ongoing objective opinion on the level and adequacy of AML/CTF compliance.

Boards and senior management not adequately engaging in and managing AML/CTF compliance has been a key feature of AML/CTF non-compliance in the AUSTRAC civil claims to date.

Internationally, it is understood that the most effective way to ensure an AML/CTF compliance-driven culture — and ensure AML/CTF compliant outcomes — is to make the board and senior management of reporting entities accountable.

AUSTRAC, as well as ASIC and APRA are focusing significant attention on how the board and senior management discharge their AML/CTF oversight responsibilities. It is anticipated that this will be an area of increasing regulatory scrutiny going forward.

training, and mitigate those inherent risks that are identified.

Finally, you need to understand the level of residual ML/TF risk you are left with after the AML/CTF controls have mitigated the inherent ML/TF risks, which needs to be managed on a continuing basis.

It should be understood whether the level of residual ML/TF risk is within your organisation's risk appetite. If not, a reporting entity has two options: either change the business to reduce the level of inherent ML/TF risk; or increase the AML/CTF controls to further mitigate the inherent risk.

It is also important that an ML/TF risk assessment is fully documented. ML/TF risk assessments can be viewed a bit like a maths exam; even if you are unfortunately subsequently judged to have the answer wrong, as long as you can demonstrate the method you used to get to the answers you will get some marks.

In recent enforcement cases, risk assessment methodologies have been a common point of failure. What lessons can we draw from these cases?

Sonja Marsic: Risk management is a discipline. Once identified, risks need to be assessed against a clear methodology. I would expect to see this methodology enshrined in the program. I would expect it to be designed so that risks can be consistently assessed across all designated services on a continuing basis.

I would expect the methodology to appropriately assess the likelihood and impact of inherent risks and then rate these risks on a scale. I would also expect the methodology to clearly document how residual risks are reached once controls are applied.

Neil Jeans: An ML/TF risk assessment should be a multi-step process supported by an appropriate methodology that forms a reasonable basis for the assessment. How to approach an ML/TF risk assessment is enshrined in the AML/CTF Rules, which require that an AML/CTF program identifies, manages and mitigates the ML/TF risks that are reasonably faced.

First, you need to identify, and adequately quantify, the inherent ML/TF risks faced with reference to the likelihood of the risk occurring and the impact on the business should the risk eventuate.

Then you need to assess how effectively the controls are set out in your AML/CTF program, such as customer due diligence or staff AML/CTF awareness

For many reporting entities, it is a struggle to ensure that risk assessments are up to date. How crucial is it that risk assessments remain a "living document" and evolve with the release of new products or a change in the threat landscape?

Sonja Marsic: The program needs to ensure that risk assessments are reviewed and updated.

We all know the external environment can be dynamic. But I often see that businesses are not creating feedback loops to ensure that trends identified through transaction monitoring or internal intelligence are then considered when updating risk assessments.

I would expect to see processes set out in the Part A program to ensure appropriate information flows so that business divisions aren't operating in silos. And this is very much part of appropriate governance and oversight.

Neil Jeans: Understanding ML/TF risk for any reporting entity is not a "set and forget" process. As Sonja points out, most reporting entities operate in dynamic external environments. However, it should also be recognised that the internal environment can be equally dynamic and can result in significant change in the ML/TF risks faced.

Reporting entities should put in place, and document in their AML/CTF programs, appropriate systems and

REUTERS/Toru Hanai

controls to ensure that their ML/TF risk assessment remains up to date. This should include a mixture of routine reviews and appropriate triggers for review based on the size, nature and complexity of the business and the criteria for review specified in the AML/CTF Rules.

In my experience, AML/CTF non-compliance is frequently predicated on an out-of-date understanding of the ML/TF risks faced.

In recent AUSTRAC enforcement cases, we've seen that risk-based controls are, all too often, not aligned with the risks. Do you have any observations on that point?

Sonja Marsic: A risk assessment on its own is nothing unless it's relied upon to inform the way in which Part A controls are designed. And this is where we often see a lot of deficiencies in Part A programs.

The purpose of a Part A program is not just to submit SMRs. It is to ensure that a business is accountable for its own risks — and is actively managing and deterring those risks.

So I would expect to see a framework within a Part A program for decision making and the implementation of fundamental controls that are aligned to a business's risks and are intended to ensure those risks are managed within [the organisation's risk] appetite. This may include controls like transaction limits or additional approvals for engaging with higher-risk customers.

And of course, under a risk-based approach, it is entirely appropriate to focus these controls on higher risks. Once a reporting entity has appropriately assessed its risk across its business, it will be able to focus its resources where it matters and to demonstrate to a regulator the basis of its risk management decisions.

Neil Jeans: An important element of AML/CTF compliance is that the ML/TF risk assessment influences the AML/CTF controls deployed as part of the AML/CTF program. This includes both preventative AML/CTF controls as well as AML/CTF detection controls.

A key factor in AUSTRAC's recent civil claims is that the AML/CTF controls — as deployed to mitigate and manage ML/TF risks by the reporting entity — were out of sync with the actual ML/TF risks faced, resulting in the exploitation of the reporting entity's services by criminals.

If AML/CTF controls are not appropriately designed with reference to the nature and extent of ML/TF risks faced, AML/CTF non-compliance is the natural outcome. The extent and impact of having non-compliant AML/CTF controls is also a key factor considered by AUSTRAC.

AML/CTF control non-compliance can take the form of both doing something or not doing something. But regardless of whether the non-compliance is an act or an omission, the exposure to the reporting entity resulting from the non-compliance is the same.

Transaction monitoring is an enormous challenge for regulated entities. When problems emerge, they can give rise to a huge number of breaches, as shown in the civil enforcement cases. Do you have any pointers for reporting entities to help them avoid this situation?

Sonja Marsic: Once a program isn't based on current and disciplined risk assessments, you very much start to see a domino effect in non-compliance. This is often very obvious in transaction monitoring. And once transaction monitoring isn't working, a reporting entity can very quickly find itself in a position where it can no longer understand its risk and respond to it appropriately.

So, transaction monitoring often comes in for a lot of attention. I would expect to see that the program is designed to appropriately cover the breadth of designated services provided by the business. Of course, it's entirely appropriate to place more focus on higher risks, but the transaction monitoring program must also be geared towards identifying emerging vulnerabilities and customers who are not transacting as expected.

Neil Jeans: It should be remembered that businesses subject to the AML/CTF Act and Rules are defined as reporting entities. This underscores the importance of transaction monitoring — and subsequent reporting.

The AML/CTF Rules make it clear that a reporting entity's transaction monitoring program needs to be risk-based and relevant to the size, nature and complexity of the reporting entity's business.

If a reporting entity fails to put in place and operate an appropriate transaction monitoring program, this undermines the AML/CTF regime by reducing the ability to identify ML/TF risks, and identify and report suspicious matters to AUSTRAC.

Inadequate and inappropriate monitoring of customer activity has been highlighted by AUSTRAC's recent civil claims, as has the failure to adequately or appropriately manage the ML/TF risks detected through transaction monitoring.

How does AUSTRAC differentiate between isolated errors and systemic reporting failures?

Sonja Marsic: Coding errors will happen. There'll be IT stuff ups. But that's not the problem. Repeated errors over time, or reporting failures that go unnoticed for years are the problems.

These systemic reporting failures generally are always the result of poor oversight and assurance and, especially in a high-volume business, they can rack up quickly.

Unfortunately, they are a big "red flag" that may prompt a regulator to look more closely at AML/CTF compliance across the board, so I'd recommend against them.

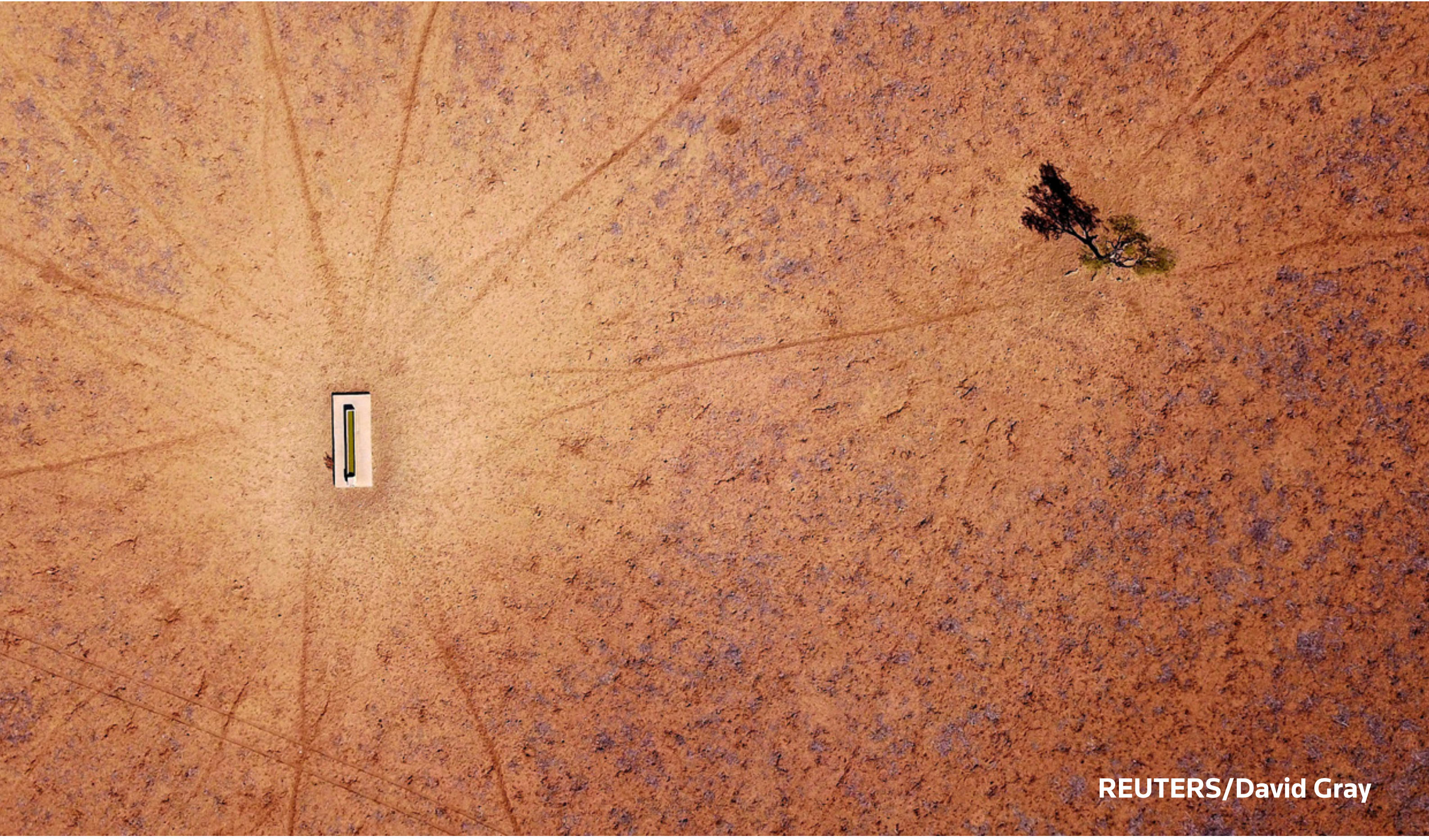
Neil Jeans: The AML/CTF regime is not, and should never be thought of as, a zero-failure regime. There is no reporting entity that is 100% compliant with the AML/CTF requirements.

Reporting entities can be complex businesses with multifaceted business processes, operating in dynamic environments. This means AML/CTF control weaknesses and failures will happen from time to time.

It is the failure to adequately prevent weaknesses or breakdowns in AML/CTF controls occurring — or not appropriately responding to identified weaknesses or breakdowns in AML/CTF systems and controls — which AUSTRAC focuses upon.

Not adequately preventing or not adequately responding to AML/CTF control failures can be indicative of a poor compliance culture and of not being committed to ensuring AML/CTF compliance, which requires further regulatory attention.

That is why it is important that if AML/CTF control failures are identified, reporting entities must establish the extent of the failure, understand the root cause of the failure, and gain an appreciation of the impact of the failure on their AML/CTF compliance. Armed with those insights, they must effectively remediate.



Does this all come back to the importance of "operational procedures" — to have them embedded in the AML/CTF program?

Sonja Marsic: Again, a program is not a piece of paper. It's not a statement of intent. It's a framework for living, breathing business processes.

A program will not be capable, by design, of identifying, mitigating and managing risks, if it is not supported by operating procedures that are embedded within day-to-day business processes.

These processes need to clearly identify who within the business is responsible for doing what and when. And they need to spell out who is accountable. An absence of such operational procedures is a real "red flag" that can prompt a closer investigation.

Neil Jeans: The AML/CTF Rules clearly require that a reporting entity's AML/CTF program adequately documents the appropriate systems and controls, and, where required, appropriate risk-based systems and controls. AML/CTF procedures are important to explain how a reporting entity is addressing a particular AML/CTF obligation or set of AML/CTF obligations.

There are undoubtedly challenges in determining to what extent AML/CTF procedures that document the AML/CTF systems and controls should be embedded into the AML/CTF program, not least as anything that is embedded within the Part A program is subject to board and senior management approval, should it need to be changed.

In the recent civil claims, AUSTRAC has argued that procedures can be part of the AML/CTF program and can be included when considering whether or not a reporting entity is achieving AML/CTF compliance.

Getting the balance right should be an important consideration for all reporting entities.

AUSTRAC has made it clear it's focusing on the importance of assurance and independent reviews. How can businesses do a better job of empowering their audit and assurance lines?

Neil Jeans: It is important to understand that information that provides or is taken as assurance comes from many sources within the business.

Assurance activity should be structured in a way that makes sense of the business while ensuring completeness and accuracy of information, to ensure that, in particular, the board and senior management can understand the level and extent of AML/CTF compliance and take appropriate action to ensure ongoing AML/CTF compliance.

This requires the flow of information from multiple sources within a business, including the front line (first line) and control/oversight functions (second line), as well as internal or external audit (third line).

The depth and frequency of information should be varied, for example, the front line should be providing information about the operation of controls more frequently and at a higher level than the control/oversight function, which should be looking at things less frequently but in more depth from the perspective of design adequacy and operational effectiveness.

Ultimately, it comes down to ensuring that information flows where it's needed from all levels to understand whether compliance is being achieved.

Sonja Marsic: In particular, I cannot see how board and senior management can be satisfied they have an appropriate risk-based program in place without assurance and without a strong third line. It is incumbent upon boards and senior management to ensure that the program is operating as intended.

That's a very comprehensive overview of the supervision and enforcement landscape. Do you have any last thoughts that might be useful for reporting entities to consider?

Sonja Marsic: There are some other "red flags" that, if your business is attuned to these things, you may be better able to head off unpleasant surprises.

- Inadequate resourcing
- High turnover of key staff from compliance functions
- Long-standing unresolved audit items
- Others in your sector have been, or are being, investigated
- Changes in interaction levels with law enforcement agencies

Question: Neil, do you have any closing thoughts?

Neil Jeans: AML/CTF compliance is based on understanding and responding to the ML/TF risks you face. Reporting entities sometimes confuse AML/CTF risk with ML/TF risk. Reporting entities only have one AML/CTF risk – the risk of non-compliance. However, they may have many ML/TF risks.

Reporting entities that focus on managing their AML/CTF risk may not adequately address their ML/TF risk, resulting in non-compliance; however, if reporting entities focus on identifying, mitigating and managing their ML/TF risk they will effectively manage their risk of non-compliance.

Sonja Marsic, senior executive lawyer, Australian Government Solicitor

Sonja conducts both a litigation and an advisory practice in the areas of, anti-money-laundering and counter-terrorism financing regulation, financial regulation, therapeutic goods regulation, and consumer law for a broad range of Commonwealth departments and agencies.

She has acted for the AUSTRAC CEO in a number of recent landmark cases under the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 resulting in significant civil penalties, including $1.3 billion against Westpac Banking Corporation and $700 million against the Commonwealth Bank of Australia.

Neil Jeans, principal consultant and founder, Initialism

Neil has a unique background in financial crime risk management, spanning over 20 years. He has worked within law enforcement agencies investigating financial crime, including domestic and international fraud and money laundering. He has also worked as a regulator, developing financial crime regulation and supervision techniques.

In the private sector, Neil has worked at senior levels managing AML, Sanctions and Anti-Bribery compliance across Europe, the US, Latin America, Asia and Australia for four global financial institutions, including one of the major Australian banks.

PICTURE: Nathan Lynch / THOMSON REUTERS