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What the Panama Papers Should Teach Companies about Money Laundering

The release of the Panama Papers shines a light on dirty money overseas.

From the Experts

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The Panama Papers are shining light on the hidden world of money laundering, providing important details on how overseas shell corporations are used to make dirty money look clean. Each new revelation—which recently have been coming almost weekly—gives federal agencies more ammunition in their fight against this brand of financial fraud.

Armed with these new disclosures on money laundering, U.S. companies should be looking beyond the headlines. They should be digging into their own operations, focusing on areas that might trigger an investigation by any of a half-dozen different federal agencies, including the Internal Revenue Service, the U.S. Drug Enforcement Agency, the Federal Bureau of Investigation and the Department of Homeland Security.

Corporate leaders, however, often understand neither the mechanics of money laundering nor the kind of compliance required by Uncle Sam. One

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reason: The money laundering process is staggeringly complex, the scope is large and operations are limited only by the launderer's imagination.

The Panama Papers are a collection of 11.5 million documents leaked from a Panama-based law firm by an anonymous tipster to German newspaper Süddeutsche Zeitung. For a year, the material was secretly and collaboratively analyzed by more than 370 journalists from over 40 countries. By agreement, they published their initial findings on the same day, April 3. Since then, new revelations have appeared as the data continues to be analyzed.

This leak disclosed the identity of the "true" owners of approximately 214,000 shell companies and billions of dollars of assets. And those disclosures barely scratch the surface. Mossack Fonseca, the Panamanian law firm that is the source of the Panama Papers, is just one firm in a single country. It has spent the past 40 years creating shell companies, but there are similar firms in dozens of countries around the world.

By providing names of the real owners of these entities—ranging from close associates of Russian President Vladimir Putin to members of China's elite—the disclosures are expected to help authorities catch terrorists, tax cheats, corrupt politicians and drug lords. The information also reveals the intricacy of these money laundering schemes.

Even in the most complex arrangement, each has three basic stages. In the placement stage, "dirty" money is deposited into a legitimate financial institution such as a bank or a brokerage firm. Next the money is "layered" by wiring it to accounts owned by shell companies, with transactions taking place over a period of time. Because these companies are based in countries with weak or nonexistent disclosure rules, the original money becomes impossible to trace. At the integration stage, the money reenters the mainstream economy through legitimate-looking transactions such as an investment in a local business or the purchase of goods at highly inflated prices from a company owned by the launderer.

There is nothing inherently illegal about a transaction involving a Panamanian company, or any off-shore entity, that holds assets. The account owner simply has to embrace transparency and comply with government disclosure requirements. But companies that fail to impose safeguards—hiring staff trained to spot problems and enacting control procedures, for example—may find seemingly legitimate transactions are anything but.

Strict controls are an absolute necessity. Consider the case of a New Hampshire race track owner. He and his partners seemed to be making far more money than seemed plausible. Still, the feds couldn't pinpoint the problem until they arrested a major drug dealer who was placing large bets at the track. The managing partner, fearful of a full-fledged investigation, avoided prosecution by explaining how the racetrack earned its seemingly outsize profits. Using the track's pari-mutuel betting operations, the owners had been able to provide patrons with large kickbacks. In pari-mutuel operations, bettors bet against each other instead of the track, and a portion of all bets is given to the house. Regardless, the federal government seized the track in a civil forfeiture proceeding because the drug dealer had used it to launder his money.

Many money laundering stories seem to involve innocuous transactions such as buying racehorses, yachts or condominiums, all of which seem far removed from the corporate world. But companies need to realize that there are lots of ways that money launderers can penetrate even buttoned-up corporate environments, whether through the computer parts supplier, the real estate company from which it leases offices or the golf club where executives mingle.

One scheme that became the focus of a congressional investigation was known as the "Toys For Drugs Black Market Peso Exchange Scheme." The owners of Los Angeles-based toy wholesaler Woody Toys Inc. received millions in cash payments from Colombian drug traffickers through small deposits into its bank accounts. The company used these deposits to buy toys from manufacturers in China, and the toys were shipped to Colombia. The proceeds from toy sales in Colombia were then used to pay back the drug traffickers.

Moreover, the federal government doesn't need a high level of proof to charge a company with conspiracy and seize goods. All that's required is probable cause. The company then has a short time to challenge the seizure. This kind of seizure is one reason that big pharma companies have adopted their own anti-money laundering protocols.

Take the case of Arthur Budovsky, who was recently sentenced to 20 years in prison after pleading guilty to running a money laundering operation. His virtual currency company Liberty Reserve allowed users to register and transfer money by supplying only a name, email address and birth date. It operated much like bitcoin trading sites. According to the U.S. Department of Justice, Liberty acted as a "shadow banking system" for criminals, and the government seized its assets. With more than 5.5 million user accounts worldwide, including some 600,000 in the U.S., there were clearly many legitimate users whose funds were seized as a result. To recover those funds, users will have to satisfy the U.S. attorney that their money was the product of legitimate transactions.

As companies revisit their own protocols to protect against money laundering, they should embrace transparency. The first step is simply making sure that they disclose their income and file any required account statements in a proper and timely way. That means reviewing what the government requires and identifying any problem areas. The criminal prosecution of HSBC Bank USA N.A. illustrated the importance of following proper procedures.

DOJ accused HSBC of willfully failing to maintain an effective anti-money laundering program and failing to conduct due diligence on bank accounts. HSBC cooperated throughout the four-year investigation and was allowed to enter into a deferred prosecution agreement. One factor the court considered was the 10-fold increase in AML staffing from 117 full-time employees and consultants to 1,147. The terms of the DPA also included forfeiting of $1.256 billion and adding a corporate monitor.

The main lesson from this prosecution is the need for transparency. A key consideration for the court in allowing the DPA was the change in HSBC's due diligence. Prior to the DPA, its policies precluded due diligence on other HSBC affiliates. Its approach was that HSBC "did not air the dirty linen of one affiliate with another." This willful blindness made it impossible for HSBC USA to discover key deficiencies in HSBC Mexico's AML program, which allowed hundreds of millions of dollars of drug money to be laundered in the U.S.

When the government began its investigation, HSBC viewed its AML program as a cost center that it kept lean to increase profits. The bank, for example, did not hire anyone to replace the North American regional compliance officer when he left the company in 2007. Instead, it shifted his duties to the North American general counsel, who clearly was unable to do both jobs.

Companies can also require transparency on the part of their business partners, customers and clients. This will allow them trace the source of funds used to finance a purchase, pay a bill or obtain goods offered for sale. Companies may even want to do their own background checks to make sure that they have a good understanding of anyone with whom they do business.

Corporate counsel should stay up to date on the Panama Papers disclosures and other money laundering cases. They offer a crash course in spotting potential problems, including the names and strategies of popular laundering structures.

As the Panama Papers' revelations work their way through the system, U.S. legislators will be looking for new ways to make it tougher to launder money. Introduced in the House earlier this year, the Incorporation Transparency and Law Enforcement Assistance Act would require companies to disclose their beneficial owners providing law enforcement with information needed to fight corruption. This legislation, if passed, would require the Treasury Department to step in to collect beneficial ownership information in cases where U.S. states are failing to.

But whether this or any other legislation eventually passes, corporate counsel should remember that the U.S. government views it as a business's obligation to make sure that it is operating within the law.

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