MONEY LAUNDERING: A CRITICAL ANALYSIS WITH SPECIAL REFERENCE TO SECURITIES MARKET IN INDIA

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ABSTRACT

This research work focuses on money laundering in the Securities Market of India. The objectives of the study are to establish the causes of money laundering in the Securities market. Financial crimes have caused the downfall of securities market in India. Massive sums of money are illegally obtained every year. For these illegally acquired funds to appear legitimately acquired and become usable, a procedure known as laundering is required. The International Monetary Fund has estimated that the global total of money laundering may range from two to five percent of the global gross domestic product, despite the fact that it is impossible to determine the actual number. The securities market has become one of the well known method used by money launderers to launder their illicit proceeds. The credibility of international financial institutions is at risk from money laundering. All of the nations that are a part of the global financial system are vulnerable to danger as a result of the financial system being undermined. The purpose of this paper is to clarify how the securities market and money laundering are related. It briefly explores money laundering from the viewpoint of the Securities market. The preventive measures are carried out by the Securities and exchange board of India (SEBI) to inhibit the infiltration of illicit money into the securities market. These include; Know your customer (KYC) norms, carrying out client due diligence (CDD), reporting any transactions that appear to be suspicious to the FIU-IND and keeping financial transaction records.

Keywords: Money Laundering, Securities market, KYC norms, Anti money laundering (AML).

1. Introduction:

A country's financial industry includes a very important segment called the security market. In today's global economy, the security market is crucial. There are many different players in the security market, such as huge financial multinational firms, stock brokers, and financial advisers. For the benefit of all classes of shareholders, including retail investors and sophisticated investors, new products and services have been developed to meet their investing needs as well as their speculative and hedging requirements. The security market is a place where deals are made electronically and across boundaries. The nature of the capital market, such as high volumes, numerous players, transaction speed, liquidity, ability to convert funds into a different asset class, worldwide nature of markets, and so on, provides an avenue for fraudsters to hide and transform the identity of unlawful funds.[1] Due to the sheer volume of transactions and ease of transferring money from one location to another, the security market is a popular site for the laundering of illicit monies. Additionally, the security market can be used for illegal gain through insider trading, fraud, and market manipulation.

"Banks, which accept cash and enable domestic and international funds transfers, have historically been the focus of money launderers. But criminals looking to conceal and muddle up illicit funds also target the securities markets, which are renowned for their liquidity. All of the different kinds of businesses that work in the securities market are susceptible to being targeted by money launderers. For instance, broker-dealers offer a range of services to institutional and retail (often individual) clients, including the buying and selling of stocks, bonds, and mutual fund shares. Only instruments with extremely few source disclosures, such as Participatory Notes and Hedge Funds, are to blame for this. These funds are well suited for usage as Laundromats. Because of the securities market's high liquidity, law enforcement agencies are concerned that criminals may try to utilise it more frequently to launder money. This is an area that requires careful attention.[2]

The three distinct phases of the conventional money laundering methodology—which typically occurs simultaneously—include the majority of the steps.

[1] Angel One, Securities Market Under PMLA: An Overview, https://www.angelone.in/knowledge-center/sharemarket/securities-market-under-pmla
[2] GAO, US Government Accountability Office Report, Anti-Money Laundering: Efforts in the Securities Industry", https://www.gao.gov/products/gao-02-111

1. Placement: - Placing filthy money is the first step in the money laundering process in to the financial system by physically placing (depositing) the cash finds into banking system.

2. Layering: - Layering is the separation of monies placed in the banking system from their sources through the development of several financial transaction levels.

3. Integration: - "Integration" refers to the last step in the money-laundering procedure where Money appears to be returned to the offenders from a reputable source during this stage. The illicit proceeds, which were initially in cash and were stacked through a series of transactions, are now completely incorporated into the banking system and now can be used for any lawful purpose.[3]

The securities market is an ideal medium for layering illicit gains, and it is also feasible that the equities market will be used throughout the layering stage of the money laundering cycle. The reported occurrences of money laundering in the securities market are more significant than those related to terrorism financing; so, this segment remains vulnerable to both terrorist financing and money laundering threats.

There are numerous methods for turning black money into white money in India as well. One of them is the stock market platform, which is controlled by SEBI, one of the most diligent and effective institutions, but is nonetheless plagued by numerous incidences of black marketing.

Furthermore, the securities industry is arguably unique among industries in that it may be used to both launder of illicit fund and generate illicit funds within the industry itself through fraudulent activities. The securities sector, along with banking and insurance, is one of the primary means through which individuals and entities can gain access to the financial system. This access allows criminals to use the financial system to participate in money laundering (ML) and terrorism financing (TF). For several years, the securities industry has been the focus of international and domestic anti-money laundering (AML) and counter-terrorism financing (CFT) initiatives.[4]

[3] James Chen-"money laundering: what it is and how to prevent it", https://www.investopedia.com
[4] FATF Report, Money Laundering and terrorist financing in the securities sector, https://www.fatf-gafi.org/

2. Characteristics of the securities market that render it vulnerable to being exploited by money launderers:

The equities market not only provides a method for illegal resources to be laundered, but it also provides a means to create illegitimate properties that will someday have to be laundered. The following characteristics of equity markets make it harder to detect potential money laundering transactions.

1. Because of the vast number of dealings and transactions, it is difficult to evaluate and examine each transaction from the standpoint of money laundering.

2. A huge number of entities providing intermediary services, which complicates efficient monitoring and enforcement.

3. Immediate liquidity and unidentified or nameless trading requirements are highly wanted by potential criminals, and the stocks market supplies these amenities for the purpose of laundering.

4. Because the securities market is competitive, it is possible that intermediaries ignore "suspicious transaction indicators" or actively participate in money-laundering schemes.

5. Because the securities market is based on a number of commission-based transactions, these professionals, such as individual brokers or brokerage firm staff, may be tempted to disregard laws or guiding principles in order to ensure that a single transaction or customer does not go to the competition.

6. The worldwide structure of the securities market, as well as cross-border transactions involving many jurisdictions, further complicate and make understanding the components of a laundering scheme complex.

7. The securities market's participation in money laundering is rarely mentioned during the placement stage. Though there are relatively few examples when illegally generated money is used to purchase shares, they cannot be ignored totally, especially in industries where obtaining cash for such purposes is prohibited or restricted.

8. The combination of the financial sector, globalisation, and electronic trading systems provides ideal conditions for conducting financial transactions across marketplaces and geographies.

9. In the securities market, due diligence procedures on consumers or the source of their funds are not always carried out properly at the first stage of the transaction. Later on, professionals assume that due diligence has already occurred; therefore they may be less vigilant, which aids in the money laundering process.

As previously said, money laundering typically occurs in three stages: placement, layering, and integration. The first stage is placement, in which illegal funds (usually cash) are converted into a non-cash item. The second stage is layering. It is the alteration and transit of these illegal funds that conceals their origin and casts doubt on the track for law enforcement and supervisory bodies/regulators. The equity market is an ideal place to compound illegal earnings. Integration is the third and final stage. It is the stage at which the launderers obtain their illegal funds in a manner that gives the funds a legal appearance. It is also envisaged that the equity market will be employed in the money laundering Layering phase.[5]

3. Offences designated as "Money Laundering" in Securities Market

As previously stated, the securities sector is not just a conduit for the laundering of criminal assets; it is also a conduit for the generation of unlawful assets that must eventually be laundered. Insider trading, market manipulation, and fraud are three securities-specific offences included in the FATF's definition of "designated offences" that lead to money laundering.[6]

3.1 Insider Trading

Insider trading is defined as the trading of a company's securities by any individual (insider) who has access to crucial non-public information about the corporation in order to benefit. That insider could be anyone, such as firm executives or directors, or their friends or relatives.

[5] Kaushik, Deepa, Prevention and control of money laundering in India issues and challenges
[6] FATF Report, Money Laundering and terrorist financing in the securities sector, https://www.fatf-gafi.org/

Illegal insider trading includes leaking such information when a person possesses any type of non public knowledge. The SEBI has policies in place to protect investors and their funds from the negative consequences of insider trading. Insider trading is a distinct element of the securities market that is used to create unlawful funds. Furthermore, proceeds from illegal insider trading operations may be laundered through the securities sector itself.

Insider trading, on the other hand, refers to cases in which a person who buys and sells stocks, whether a corporate insider or not, violates a fiduciary responsibility or other relationship of trust and confidence while in possession of material, non-public information about the security. In some jurisdictions, this includes scenarios in which a person in possession of material, non-public knowledge transfers this information to someone else for trading purposes, where the recipient of the information may also violate insider trading laws depending on the circumstances.

3.1.1 Suspicious Indicators Relating to Insider Trading

1. Just before news is released that affects the price of the security, the customer makes a sizable purchase or sale of that security or an option on it.

2. Shortly before a purchase, the customer's account is opened or significantly funded; and

3. In conjunction with a substantial announcement concerning a security, the client sells his or her position in the security.

4. The customer's purchase is inappropriate for his or her investment profile. For example, the customer may have never invested in stock securities before, but does so at an advantageous time.

5. The customer lives in the locality where the issuer is located;

6. It is known that the customer has friends or family who work at or for the securities issuer.

3.2 Market Manipulation

Market manipulation is defined as any activity intended to mislead or confuse investors in order

to deceive them by controlling or artificially disrupting the market for a certain security. The manipulator's primary goal is to raise or lower the amount and price of a share or instrument in order to profit from a value disparity. It is a deliberate attempt to obstruct the free and legitimate economic activities of the securities market. Manipulators use a variety of ways to generate unlawful income.

The most prevalent type of market manipulation tactic is known as a "pump-and-dump" scheme. This strategy involves promoting a company's stock using incorrect or misleading information.

A remark frequently used in combination with securities trades that enhance the price of the security or give the impression that the securities trading volume is greater than it is. As a result, the security price is artificially low. The security is inflated ("pumped") and subsequently sold ("dumped") for a profit. The underlying security is frequently low priced, illiquid, and trades in small volumes.

3.2.1 Suspicious Indicators Relating to Market Manipulation

1. The customer trades heavily or repeatedly in securities that are scarce, cheap, or difficult to value.

2. The issuing company's corporate structure has undergone frequent or continuous modifications, and/or its business strategy or line of business has undergone frequent major changes.

3. Officers or insiders of the issuing company have ties to other low-priced, illiquid, or low-volume businesses.

4. The issuing company's officers or insiders have a history of regulatory violations;

5. The issuing company has previously been suspended from trading;

6. The transactions of a customer demonstrate a pattern of obtaining physical securities or incoming share transfers that are later sold, with the money wired out of the account.

3.3 Securities Fraud

Securities fraud primarily refers to deceptive actions associated with the tender and sale of stocks. In this case, securities fraud includes market manipulation and insider trading.

Such scams are typically performed in the course of unregulated schemes that entail the mobilisation of funds/savings from the general public for purposes such as uncontrolled portfolio management and uncontrolled collective investment plans, among others. Even while such schemes may not explicitly include the use of securities markets, equities, or intermediaries, the manner in which they are presented frequently causes them to be categorised as securities and so subject to the oversight of securities authorities.

3.3.1Suspicious Indicators Relating to Securities Fraud

1. The customer creates many accounts for various legal organisations under his control.

2. Many cheques or wire transfers are received by the consumer from unconnected third parties.

3. The consumer distributes incoming third-party deposits among multiple accounts.

4. The client makes a large number of outgoing payments to third parties at the same time as the customer receives a large number of incoming third-party cheques or wire transfers.

5. The customer's profile does not indicate a valid business justification for receiving numerous third-party deposits; and

6. The money is designated for investment on the cheques or wire transfers.[7]

4. Regulatory guidelines issued by SEBI on Anti-Money Laundering obligation of securities market intermediaries under the prevention of money laundering act, 2002

The Securities and Exchange Board of India (SEBI) periodically releases regulatory recommendations on Know Your Customer (KYC) standards, Anti Money Laundering (AML)

[7] Supra note 6

standards, and Combating of Financing of Terrorism (CFT). It is an obligation of securities market intermediaries under the PMLA, 2002 to follow these guidelines issued by the SEBI to prevent money laundering in Indian securities market.[8]

4.1 Know your customer (KYC) Policy

KYC policy is an essential component of Customer Due Diligence (CDD) procedures that must be recognised by all financial firms, including equity market intermediaries. The main obligation of KYC is to recognise clients and establish their individuality through the use of a reliable, independent source of papers, statistics, or information. In cases where the client is a legal personality/agreement, the KYC policy also includes identifying and confirming the beneficial owner's identity.

Each registered intermediary must apply the anti-money laundering rules outlined in the PMLA through established processes. Such procedures must comprise, among other things, the three specific parameters relevant to the overall 'Client Due Diligence Process'.

a) Policy for acceptance of client

b) Procedure for identifying the client

c) Transaction monitoring and reporting especially suspicious transaction reporting (STR)

4.2 Client Due Diligence (CDD)

Obtaining enough information to identify individuals who beneficially own or control the securities account when it is clear that securities bought or maintained through an account are beneficially owned by someone other than the client, that person must be identified utilising client identification and verification procedures. The beneficial owner is the natural person or people who ultimately own, control, or influence a client and/or the people on whose behalf a transaction is being carried out. It also includes those individuals who have ultimate effective

[8] SEBI, Regulatory guidelines on Anti-Money Launder obligation of securities market intermediaries under the PMLA, 2002 https://www.sebi.gov.in

control over a legal person or arrangement. Verify the client's identification by employing documents, data, or information from credible, independent sources.[9]

4.3 Identification of beneficial owner

As we all know, money launderers abuse and employ legal personalities/arrangements in order to make their illegal riches legal. Therefore identifying and recognising beneficial ownership (BO) is the most important aspect of customer due diligence. As a result, every authority was requested to notify about the guiding principles that were established in the topic of identifying BO.

"In its recently announced guidelines, the FATF has offered a step-by-step process for determining beneficial ownership in the case of clients who are legal persons/arrangements." SEBI has given its intermediaries with extensive rules for identifying and verifying beneficial ownership. These instructions, which were announced in January 2013, are in accordance with the updated FATF standards and are relevant to the whole financial sector.

4.4 Record Keeping

Registered intermediaries must comply with the record-keeping standards outlined in the SEBI Act of 1992, its Rules and Regulations, the PMLA, and other relevant legislation, Rules, Regulations, Exchange Bye-laws, and Circulars. Registered Intermediaries must keep records that are sufficient to reconstruct individual transactions (including the quantities and types of currencies involved, if any) in order to offer evidence for criminal prosecution if necessary.

If there is any suspected drug-related or other laundered money or terrorist property, the competent investigative authorities must trace through the audit chain in order to reconstruct a financial profile of the suspect account. To facilitate this reconstruction, registered intermediaries must keep the following information for their clients' accounts in order to maintain a satisfactory audit trail.

a) The beneficial owner of the account;

[9] SEBI, Regulatory guidelines on Anti-Money Launder obligation of securities market intermediaries under the PMLA, 2002 https://www.sebi.gov.in

b) The volume of the funds flowing through the account; and

c) For selected transactions:

- The origin of the funds
- The form in which the funds were offered or withdrawn, e.g. cheques, demand drafts etc.
- The identity of the person undertaking the transaction;
- The destination of the funds;
- The form of instruction and authority.

More particular, all intermediaries must implement the system of keeping proper records of transactions required by Rule 3 of the PML Rules, as detailed below.

1. Any cash transactions in excess of 10 lakh rupees or their equivalent in foreign currency
2. Any series of cash transactions that are closely related to one another and each have an individual value of less than Rs. 10 lakh or the equivalent in another currency, provided that the monthly aggregate value of all such series of transactions is greater than Rs. 10 lakh or the equivalent in another currency.
3. All monetary transactions in which fake or forged money notes or banknotes have been used as if they were real, or in which any valuable security or document has been faked in order to facilitate the transaction;
4. Any suspicious transactions, whether or not they are cash transactions or otherwise mentioned by the Rules.[10]

4.5 Records of information reported to the Director, Financial Intelligence Unit India (FIU IND)

For a period of five years following the date of the transaction between the client and the

[10] Prevention of money laundering Rule, Rule 3

intermediary, Registered Intermediaries shall maintain and preserve the records of information related to transactions, whether attempted or completed, which are reported to the Director, FIU-IND, as required by Rules 7 and 8 of the PML Rules.[11]

4.6 Monitoring of Transactions

It is essential to regularly monitor transactions to guarantee the efficiency of the AML procedures. This is only achievable if the intermediary is aware of the client's typical behaviour so that it can see any differences in transactions or activities.

The intermediary must pay close attention to any intricate, exceptionally big transactions or patterns that seem to have no apparent economic sense. For each class of client accounts, the intermediary may set internal threshold limitations and pay close attention to transactions that go beyond these restrictions. The background of such transactions, including any supporting paperwork (papers, office records, memos, clarifications sought), as well as their intended use, must be carefully reviewed. Findings must be documented in writing. Additionally, during audit, inspection, or as needed, such findings, records, and related documentation must be made available to auditors as well as SEBI, stock exchanges, FIUIND, and other appropriate Authorities. Five years after the date of the transaction between the customer and the intermediary, these records must be kept and preserved.

The intermediary must make sure that a record of the transactions is preserved and kept in accordance with Section 12 of the PMLA and that any suspicious transactions or other transactions that have been reported under Section 12 of the Act are reported to the Director, FIU-IND. Additionally, and suspicious transactions must be routinely reported to the intermediary's higher authorities. Additionally, the compliance unit of the intermediary will at random review a sample of transactions made by clients to remark on their nature, namely whether or not they are suspicious transactions.[12]

4.7 Monitoring and Reporting of Suspicious Transaction

Intermediaries must make sure that the proper measures are taken to make it possible to identify suspicious transactions and that the proper procedures are in place for reporting suspicious

[11] Prevention of money laundering rule, Rule 7 & Rule 8
[12] Prevention of money laundering act 2002, Section 12

transactions. Intermediaries must base their decision-making on the definition of a suspicious transaction found in the PML Rules, as updated from time to time.

The following is a list of situations that could include questionable transactions. This list is merely illustrative, and the history, specifics of the transaction, and other facts and circumstances will determine whether a certain transaction is suspicious or not.

1. consumers who appear uncooperative or whose identity verification appears challenging

2. Asset management services for clients whose sources of funding are unclear or inconsistent with their ostensible standing or commercial activities

3. clients sending or receiving huge sums of money from or to foreign countries with instructions for cash payments

4. Unusual business activities reported to be involved in the export-import of minor items by CSCs and firms run by offshore banks and financial services

5. transfer attempts of investment revenues to ostensibly unrelated third parties;

6. Substantial increases in business without apparent cause

7. Clients based in high risk jurisdictions

Any suspicious transaction must be reported right away to the intermediary's money laundering control officer or another designated authority. The disclosure could take the form of a thorough report that makes particular mention of the clients, transactions, and kind or basis of suspicion. However, it must be made sure that client interactions continue as usual until instructed differently, and the customer must not be informed of the report or suspicion. In exceptional cases, authorization to operate the account may not be granted, and transactions may be halted in one or more of the jurisdictions involved in the transaction or other action may be taken. Client identification data and CDD information, transaction records, and other pertinent data shall be promptly accessible to the Principal Officer/Money Laundering Control Officer and other necessary compliance, risk management, and related staff members.

4.8 Listed company supervision

The Listed Company Supervision department organises ongoing reviews of all companies that trade stocks. For conveniences, directors and officers are inspected. People with questionable prior records are removed from positions of authority in organisations. Press releases are checked for general decency and compliance with SEBI rules. In addition to other things, audited financial reports are evaluated as part of the oversight of listed firms to ensure that money is not being spent for purposes that shareholders have forbidden. Business is halted in violating organisations until the situation improves in order to enforce compliance.

4.9 Trading Supervision

Trading Supervision monitors trading in real-time using proprietary software inconsistencies in volume or price are immediately investigated. The employees of supervisory bodies have the authority to request clarification from issuers regarding any unexpected changes and to seek brokerage reports to identify the parties responsible for the transactions. Trading is halted until the crucial information is made available in the event that the issuers lack a justifiable reason for a significant change in volume and price.

4.10 Reporting to the Financial Intelligence Unit India (FIU-IND)

According to the PML Rules, intermediaries must inform the Director of the Financial Intelligence Unit-India (FIU-IND) of information pertaining to cash and suspicious transactions.

The reporting requirements and formats that are available on the FIU-IND website must be carefully read by intermediaries. Intermediaries are not allowed to impose any limitations on activity in accounts where a STR has been made. It is against the law for intermediaries and their permanent and temporary directors, officers, and employees to reveal ("tip off") the existence of a STR or other associated information that has been reported to or given to the FIU-IND. This ban on giving away information applies not only to the filing of the STR and/or accompanying documents, but also to the time before to, during, and following the submission of a STR. In order to prevent tipping off the client at any stage, it must be ensured. It is made clear that registered intermediaries must file a STR if they have reasonable grounds to believe that the transactions include the profits of crime, regardless of the amount of the transaction or

the threshold limit intended for primary offences listed in section B of Schedule of PMLA, 2002.

5. Conclusion

The securities market itself can only be utilised to generate illegal profits from money that may have come from a legal source. When these unlawful revenues are realised, they pave the door for practically "automatic" laundering. The use of the stocks market may become a greater draw for people who are looking to conceal unlawful earnings or actively desire to produce them as a result of tighter laws in the areas historically more associated with money laundering, such as banking. The securities markets do not typically see the broad use of money, and funds are typically introduced through other regulated industries. The industry and its regulators must take the necessary steps to ensure that reliance is only placed on third parties with sufficient AML/CFT systems and controls, even though relying on other parts of the financial sector to conduct certain aspects of CDD can be a perfectly acceptable way to facilitate transactions in the global financial system. Finding the reason and intended nature of a transaction involving funds from another area of the financial industry remains a crucial factor, and CDD itself is more than just client identification. The securities markets are allegedly home to a sizable amount of the money laundering threat. Criminals are more progressive in this area than law enforcement agencies. The examples mentioned are but a fraction of the countless techniques presently in use by crooks in the sector. Securities regulators and law enforcement organisations should improve their investigative skills and work together to control the issue.

The study presented above demonstrates how easy it is to conceal the source of money by using transactions on the securities market to launder it. Additionally, since the brokers are not required to break down transactions as they occur, mechanisms of profit and loss allocation that permit the movement of funds from one person to another may be formed. It's also important to keep in mind that mechanisms like the internalisation of commands only make covert transactions and coordinated activities more likely. Finally, there are methods for holding assets in a way that gives them an appearance of a lawful origin.

The major requirement of India's anti-money laundering legislation is that firms operating in the securities market must adhere to a number of regulatory criteria, the most important of which is recognising and identifying the consumers. In situations when clients are operating on

behalf of the investors, this is not only concerned with the formal issues but also with the identification of the final investors.

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