Snow Washing Securities:

A Review of Money Laundering in

Canada's Capital Markets

Research Project for Emerging Issues/Advanced Topics Course

Master of Forensic Accounting Program

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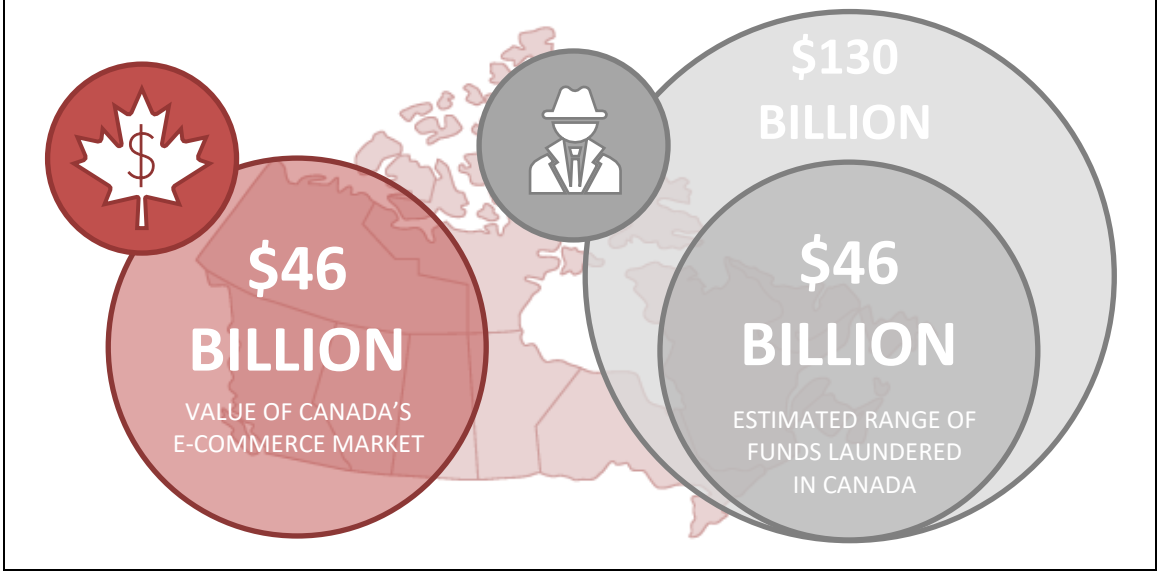
A – GLOSSARY

ACAMS	Association of Certified Anti-Money Laundering Specialists
AML	Anti-money laundering
BCSC	British Columbia Securities Commission
CSA	Canadian Securities Administrators
FATF	Financial Action Task Force
FINTRAC	Financial Transactions and Reports Analysis Centre of Canada
IIAC	Investment Industry Association of Canada
IIROC	Investment Industry Regulatory Organization of Canada
IMF	International Monetary Fund
KYC	Know Your Client
MFDA	Mutual Fund Dealers Association of Canada
MSB	Money Services Business
OSC	Ontario Securities Commission
PCMLTFA	Proceeds of Crime (Money Laundering) and Terrorist Financing Act
RCMP	Royal Canadian Mounted Police

B – EXECUTIVE SUMMARY

It is estimated that approximately $46 billion is laundered through Canada annually.[1] Another statistic based on research from the C.D. Howe Institute estimated that up to $130 billion may be laundered through Canada each year.[2] This is obviously a significant range but given the inherent nature of how a money laundering scheme operates, it is extremely difficult to pinpoint a single value or even confirm whether an estimate is truly representative of the actual figure. But even at the low end, $46 billion worth of illicit transactions is enormous. To put it in perspective, a J.P. Morgan study of e-commerce trends in Canada valued the Canadian e-commerce market at $46 billion[3], which means our legitimate e-commerce presence is equivalent to Canada's underground economy – with some estimates suggesting it could be higher, as emphasized in **Table 1** below. Needless to say, Canada has a money laundering problem.

Table 1 – Canada's Two Economies



[1] Maloney, Maureen, "Combatting Money Laundering in BC Real Estate," Cullen Commission, March 2019.
[2] Comeau, Kevin, "Why Canada's money-laundering problem is far bigger than we think," *Financial Post*, 28 May 2019.
[3] "E-commerce Payments Trends: Canada," *J.P. Morgan*, 2019.

Canada's reputation for attracting money launderers gained such widespread attention that the phenomenon was deemed "snow washing". Headlines on money laundering often address the real estate and gambling industries in Canada, but one area that is virtually unexplored is money laundering through securities. Canada's capital markets are a significant source of economic activity across the country. In 2018, the IIAC reported a total of $1.6 trillion investment assets under management across 7 million full-service brokerage accounts and almost 10,000 advisors.[4] Our capital markets execute a significant number of transactions from varying sources and a key component to our AML regime is ensuring those sources are legitimate. Market participants are required to collect KYC information to confirm the identify of their clients, and while this may be easy for the average investor, criminals go to great lengths to conceal their identity by using private companies as investment vehicles to appear as though their transactions are lawful.

One of the highly sought-after solutions for Canada's money laundering problem is the creation of a publicly available registry of beneficial ownership. Bad actors target Canada because our laws do not require disclosure of the true owner of a legal entity, allowing money launderers both foreign and domestic to remain anonymous and further conceal the criminal origins or their illicit funds. The solution of a beneficial ownership registry is suggested broadly to assist all industries in the detection and prevention of money laundering, but there are direct benefits to compliance with Canada's capital markets regulation, particularly with meeting KYC obligations. Market participants must understand who they are transacting with and that includes knowing the identify of their clients. While securities law requires public companies to disclose major shareholders,

[4] "Canada's Investment Industry: 2018 at-a-glance," *IIAC*, 2018.

private companies can be registered under any name, such as a lawyer or designated individual, thereby concealing the true "client".

B-1 – Approach

This research paper endeavours to build out the evolution of money laundering in Canada's capital markets by starting with the fundamentals and an overview of the key players in Canada's regulatory landscape. Following, we will dive into the history of money laundering through securities and assess how Canada's AML regime has an impact on market participants. The paper concludes with key takeaways and a discussion of the future opportunities and challenges around AML in Canada's capital markets. Each section of the paper will generally follow the same three-pronged approach by presenting the facts and research around money laundering in Canada, analysis of the relevant overlap with the capital markets, and a discussion of how both areas come together, particularly as it relates to compliance with Canada's AML regime.

B-2 – Objectives

1. Explore and evaluate Canada's anti-money laundering efforts and the relevant securities legislation that governs our capital markets,
2. Analyze statistics and case law in Canada as it relates to the nature and extent of money laundering in Canada's capital markets,
3. Identify challenges in detection and investigation of money laundering in Canada's capital markets, including the cost of compliance, and
4. Evaluate potential opportunities, recent developments, and challenges around AML efforts in Canada's capital markets.

C – FUNDAMENTALS AND REGULATORY LANDSCAPE

Money laundering is not a uniquely Canadian crime, but Canada has certainly gained the unwanted attention of criminals with dirty cash in search of a safe haven for their illicit funds. Before diving into the nuances of money laundering in the scope of Canada's capital markets, the sections below will review several of the key concepts around money laundering and the regulatory landscape in Canada.

C-1 – Money Laundering Foundations

Money laundering is the process through which criminals take their illegally obtained funds and attempt to hide those funds in the mix of legitimate transactions. As one writer describes it, "laundering, the near-invisible financial fiddling to make the money from crime look respectable so it can be openly used, is an essential element of the cycle that keeps mobsters and transnational crime bosses in business."[5] After a bad actor is in possession of his or her ill-gotten funds, the three-step process of money laundering is initiated: placement, layering, and integration. Earlier this year, staff at *The Walrus* created an infographic "A Crash Course on Money Laundering", provided in **Table 2** below, which depicts a good overview of each step in the money laundering process, as well as some examples of how each step is carried out.

[5] Humphreys, Adrian, "The underworld laundromat: How to clean $10 million in mob money," *National Post*, 5 December 2019.

Table 2 – "A Crash Course on Money Laundering" by The Walrus[6]

Placement

A person who is in possession of illicit cash or other funds first needs to place it into the existing financial system. To do so, they will move the funds away from the illegal source of the money and into another, less suspicious place . It is common to funnel the money through systems with weak anti-money-laundering controls, such as casinos or offshore accounts that allow for anonymous ownership. A person might also transfer cash into another form, such as a digital currency.

Currency smuggling

A money launderer may hire a third- party courier to illegally transport funds across international borders, or even purchase a shipping business to store cash inside of transported goods.

Gambling

A person might buy casino tokens or place bets on sporting events and disguise the funds as "winnings."

Smurfing

To avoid bank investigations that might result from a larger deposit, the money may be broken up into smaller amounts and deposited across multiple bank accounts.

Layering

To avoid detection, a criminal must do more than relocate the funds once or transfer them into another form. A launderer will funnel their money through layers of financial transactions to create a more complicated money trail, making its origins more difficult to trace. They may also move the money abroad, using shell companies that allow for anonymous ownership, to help distance the funds from their source.

Purchasing assets

A common method for concealing funds is to purchase assets, such as real estate. A launderer will use a shell corporation, a fake name, or a third-party owner to make the purchase without their identity being revealed. Material assets, such as gold or artwork, are also common purchases.

Mirror Trading

A mirror trade is when two stock market transactions are performed simultaneously in order to move funds across international borders. One company or entity will sell stock, while the other entity, in a separate location, will purchase the equivalent value of stock. The transactions cancel each other out, but work to move the money across international borders and put it through more layers of transactions.

Selling or Maintaining Assets

A person may choose to sell any property or assets bought during layering, so that the money will appear to be the result of real estate or other financial holdings. To help avoid detection, money launderers often choose to store wealth in the form of expensive assets, such as art or real estate.

Integration/Extraction

For the launderer to spend their funds without suspicion, they must extract their money from the various places it was stored and return it to themselves masked as legitimate business or investment income. This can happen by presenting the money as legal earnings from transactions that were established during layering, or by selling property or other assets that were bought.

Fake Loans

A launderer may send themselves a "loan" from a front company located in a country with strong corporate privacy laws. This method reduces income taxes and even allows the launderer to repay the money to themselves with interest, a way of accounting for further illicit funds.

Inflated Business Income

The laundered money is reported as inflated profit alongside a business's legitimately earned income. This works well with cash-intensive businesses, such as bars and restaurants. This is similarly done through real estate, where money can be claimed as rental income from fake tenants.

[6] "A Crash Course on Money Laundering," *The Walrus*, 27 March 2020

These three steps represent the foundation of a money laundering scheme anywhere in the world, though they tend to be far more sophisticated networks of transactions. What differentiates one jurisdiction from another are the regions or industries that are most vulnerable to money laundering. The sections below provide an overview of some of the key regulatory bodies and organizations that oversee or influence Canada's AML regime, and where focus has shifted to vulnerable areas at risk of attracting money launderers.

C-1-1 – Financial Transactions and Reports Analysis Centre of Canada

The Financial Transactions and Reports Analysis Centre of Canada ("FINTRAC") is the regulatory "watchdog" when it comes to anti-money laundering and terrorist financing in Canada. In their 2018-2019 annual report, FINTRAC describes their mandate as follows:

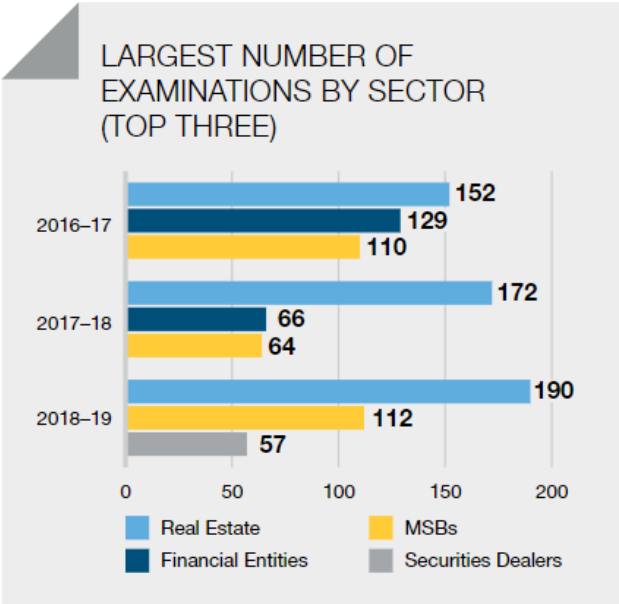
> *"[FINTRAC] produces actionable financial intelligence in support of investigations of Canada's police, law enforcement and national security agencies in relation to money laundering, terrorist activity financing and threats to the security of Canada. FINTRAC also generates valuable strategic financial intelligence, including specialized research reports and trends analysis, for regime partners and policy decision-makers, businesses and international counterparts that shines a light on the nature, scope and threat posed by money laundering and terrorism financing. The Centre is able to fulfill its financial intelligence mandate by working with Canadian businesses to ensure compliance with the Proceeds of Crime (Money Laundering) and Terrorist Financing Act. Compliance with the Act helps to*

prevent and deter criminals from using Canada's economy to launder the proceeds of their crimes or to finance terrorist activities. It also ensures that the Centre receives the information that it needs to produce financial intelligence for Canada's police, law enforcement and national security agencies."[7]

In order to fulfill their mandate and ensure compliance with the PCMLTFA, FINTRAC conducts compliance reviews every year. FINTRAC relies on a risk-based approach when determining which reporting entities will be subject to a compliance review in a given year – it would not be feasible to review the compliance programs of every entity that reports to FINTRAC. According to their 2018-2019 annual report, FINTRAC conducted nearly 500 compliance reviews throughout the year, but what is interesting is how they redistributed the focus of their examinations compared to prior years. As seen in **Table 3** below, FINTRAC placed a greater emphasis on compliance reviews in the real estate sector and money services businesses over the 2018-2019 period. In addition, where reviews of financial entities ranked in the top three for the years prior, reviews of securities dealers have taken a top spot. Although the annual report does not specifically comment on why we see this sudden change, FINTRAC did explain that "the Centre has focused its efforts on more complex, lengthy and in-depth examinations of larger businesses in higher-risk sectors in order to determine how effectively they are fulfilling their compliance obligations.[8]

[7] "FINTRAC Annual Report 2018-2019," *FINTRAC*. Accessed 19 June 2020. (page 6)
[8] Ibid. (page 21)

Table 3 – FINTRAC Compliance Reviews, 2018-2019



Reading between the lines, FINTRAC has evidently identified or assessed some level of increased risk around money laundering through securities dealers, given they have included them in the top three sectors in need of compliance reviews. It is likely that part of the reasoning behind this shift in focus comes from the highly publicized issue around lack of transparency in beneficial ownership, which falls directly under the compliance requirements for securities dealers. On the "Reporting Entities" section of their website, FINTRAC highlights the KYC obligations of securities dealers to include KYC requirements, which specifies beneficial ownership requirements.[9]

[9] "Reporting Entities: Securities Dealers," *FINTRAC*, 6 June 2020.

C-1-2 – Royal Canadian Mounted Police

The Royal Canadian Mounted Police ("RCMP") Proceeds of Crime Branch operates with the goal of dismantling criminal organizations and preventing them from regrouping. There are various partner agencies involved, for which the RCMP is the lead agency, including: Canada Border Services Agency; Canada Revenue Agency; and several others. The RCMP's money laundering unit receives intelligence from several groups and agencies, especially FINTRAC, and then considers whether a criminal investigation is warranted.[10] The RCMP evidently plays an important role in the prosecution of money launderers and as such, they have been given a significant spotlight – and budget – to focus on cleaning up Canada's dirty cash problem. Last year, the federal budget earmarked "$70 million over five years to create a money-laundering task force, increase expertise in trade-based money laundering and support financial intelligence gathering. Another $68.9 million was earmarked to strengthen RCMP resources. RCMP officials said the force is working with government to assess options on boosting investigative capacity."[11]

C-1-3 – Financial Action Task Force

The Financial Action Task Force ("FATF") is a global AML standard-setting body with over 200 countries and jurisdictions committed to implementing regulatory reforms around money laundering and terrorist financing. As described

[10] "Proceeds of Crime Program," *Royal Canadian Mounted Police*, 28 July 2009.
[11] Hoekstra, Gordon, "COVID-19: Some delay in anti-money-laundering measures because of pandemic, but progress being made," *Vancouver Sun*, 3 May 2020.

on their website, "the FATF reviews money laundering and terrorist financing techniques and continuously strengthens its standards to address new risks…the FATF monitors countries to ensure they implement the FATF Standards fully and effectively, and holds countries to account that do not comply."[12] With respect to Canada, the FATF published a report in 2016 after a review of Canada's measures to combat money laundering and terrorist financing. The overall summary was that "Canada has a strong anti-money laundering and combating the financing of terrorism (AML/CFT) regime which achieves good results in some areas but requires further improvements to be fully effective."[13] While the report did not address any specific risks among Canada's capital markets, one of the many shortcomings pointed out by FATF was lack of transparency with respect to beneficial ownership, which carries implications for market participants.

The general theme on this issue throughout the report is that Canada does not enforce any legal requirement to record or track the beneficial owner of a private entity, and the anonymity allows for concealment of potentially illicit funds.[14] The FATF specifically noted that "the federal and provincial company registries record some basic information, but do not generally collect information on beneficial owners. Verification mechanisms for registered information are not in place [whereas] for public companies listed on the stock exchange, disclosure requirements exist for shareholders with direct or indirect control over more than

[12] "Who we are," *FATF*, Accessed 19 June 2020.
[13] "Canada's measures to combat money laundering and terrorist financing," *FATF*, 2016.
[14] Ibid (page 16)

10% of the company's voting rights."[15] As a result, transparency of beneficial ownership information was one of the many key recommendations for improvement of Canada's AML regime.

C-2 – Capital Markets in Canada

Each of the regulatory agencies described above plays an important role in maintaining and enforcing Canada's AML regime. The issue of beneficial ownership transparency highlighted by the FATF is the key component that overlaps with obligations under securities legislation and the concerns of money laundering in Canada's capital markets. The capital markets in Canada are regulated by the 13 provincial and territorial securities regulators, all of which come together under the umbrella of the Canadian Securities Administrators ("CSA"). As described on it's website, "the CSA brings provincial and territorial securities regulators together to share ideas and work at designing policies and regulations that are consistent across the country and ensure the smooth operation of Canada's securities industry."[16] Registrants and issuers are required to comply with the securities legislation of the jurisdictions in which they operate, and while this is separate from the laws and reporting requirements enforced by FINTRAC, there are some indirect obligations under securities law to ensure market participants uphold the AML regime.

In April 2016, the Ontario Securities Commission ("OSC") held a Registrant Outreach seminar to discuss obligations under the PCMLTFA. The OSC noted how

[15] Ibid (page 167)
[16] "Who we are," *Canadian Securities Administrators*. Accessed 19 June 2020.

reporting obligations under section 83.11 of the Criminal Code of Canada apply to entities "authorized under provincial legislation to engage in the business of dealing in securities, or to provide portfolio management or investment counseling service."[17] The presentation went on to specify expectations of the OSC and some of the areas reviewed for compliance, including:

- Policies and procedures around money laundering, including the AML Officer, risks of the business and mitigation, training and compliance for employees, regular review of policies and procedures, reporting and record keeping, and politically exposed persons;
- KYC requirements and how the market participant identifies their clients; and
- Requests to review reports issued to the market participant by FINTRAC.[18]

The OSC presentation concluded with some of the common deficiencies identified in this area such as weak policies and procedures, or failure to file monthly reports. But the deficiency of greatest concern was the lack of proper identification of clients and the lack of appropriate records to substantiate client identity. One case was specified in which the Chief Compliance Officer ("CCO") "signed documents attesting that they had met with clients and verified client identity. However, the CCO had never met the clients, but rather delegated this function to anther person. The Director [of Compliance and Registrant Regulation] suspended the firm's registration indefinitely."[19]

[17] Caruso, Chris, "Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA)," *Ontario Securities Commission,* 14 April 2016. (page 4)
[18] Ibid (page 7)
[19] Ibid (page 9)

C-3 – Snow Washing

The subject of money laundering in Canada gained such prevalence and media attention that the issue received its own nickname. The term "snow washing", creatively depicted in **Table 4** below, was created as a distinctly Canadian reference for money laundering in the country. Victoria Sztanek, a writer for *ACAMS Today*, summarized the origin and definition of the term as follows:

> "*After the release of the 2016 Panama Papers, the country was dubbed the world's newest tax haven. Criminals were found to engage in what was coined "snow washing," a way of exploiting the nation's clean reputation to generate an air of legitimacy when conducting illegitimate transactions*."[20]

Table 4 – "Snow Washing" by Dave Simonds[21]

[20] Sztanek, Victoria, "Eyes on Vancouver: Money Laundering in Canada," *ACAMS Today*, 26 December 2019.
[21] Ibid

Bad actors with dirty funds take advantage of the distinctly honest reputation of Canada as a country and hide behind layers of foggy corporate paperwork – burying themselves in the snow, so to speak. While there are certainly several layers of oversight around public companies, the private space in Canada is far less transparent. Some of the reports that surfaced in 2016 disclosed cohorts of students in British Columbia who apparently owned multi-million dollar properties without any source of income – turns out they were essentially pawns, named as representatives for several companies while the true owners remained anonymous because that information is not legally required to be disclosed.[22] In an effort to bring greater awareness to this issue, an initiative was started to highlight and keep track of progress in combatting the issue in the form of #endsnowwashing.

The #endsnowwashing Coalition ("The Coalition") is jointly led by Publish What You Pay Canada, Transparency International Canada, and Canadians for Tax Fairness – along with several other organizations who support The Coalition – to advocate for a publicly available registry of beneficial owners in Canada. As they describe it, "by remaining anonymous, individuals can use dirty money to buy real estate or funnel the funds through company operations. Once the property is sold, or once company shares are sold, the secret owner can benefit from the proceeds of the sale."[23] The Coalition's efforts are geared towards snow washing in every form, but with respect to money laundering through securities, they proficiently summarized the impact on our capital markets, as seen in **Table 5** below.

[22] "Snow-Washing: Canada frets about anonymously owned firms," *The Economist*, 4 January 2018.
[23] "What is snow-washing?" #*endsnowwashing*. Accessed 17 June 2020.

Table 5 – Abuse of Secret Companies in Canada by Money Launderers

"Secret companies have been abused by money launderers and have contributed to market volatility in international capital flows and exchange rates

One of the reasons for creating a shell company is to launder the proceeds of crime, which has severe socioeconomic implications. In Canada alone, there are estimates of between $100 to $130 billion being laundered each year. Unlike legitimate investors, money launderers do not seek profit maximization.

They seek a reduced risk of getting caught for their crimes. Their lack of vested interest adversely affects legitimate business.

One only needs to look at British Columbia's Lower Mainland, where a firm called Silver International allegedly acted as an underground bank for money flowing from China. Money services businesses in Canada are federally obligated to register their business and create customer profiles. Silver International did neither and was alleged to have laundered up to $220 million in a year.

Money laundering of this magnitude has ripple effects across the economy by creating unpredictable changes in demand and extreme volatility in international capital flows and exchange rates. As a result, honest business owners, entrepreneurs, and investors are those who bear the brunt of money laundering in the economy."[24]

As noted in this concise explanation, one of the key issues that is specific to the nuances of money laundering in the capital markets is the lack of profit motive. This links

[24] "The Impact of Criminal Misuse of Secret Companies on Canadian Small-Medium Enterprises and Rationale for a Publicly Accessible Company Register of Beneficial Owners," #*endsnowwashing*. Accessed 20 June 2020.

back to one of the examples provided by *The Walrus* in **Table 2** above which describes the technique of mirror trading as a way for criminals to move funds across jurisdictions. This demonstrates how money laundering is not a victimless crime as investors, and the economy as a whole, are indirectly impacted by the market fluctuations from these illicit transactions. It is estimated that the money laundering problem in British Columbia's real estate industry has contributed to a 5% increase in home prices.[25] While we do not have a quantifiable estimate for the impact on the Canadian capital markets, we can assume the impact would be equivalent at minimum, but likely much higher given the vast difference in volume of real estate transactions versus market transactions in a given year (or even a day). Former RCMP organized crime and money laundering investigator, Henry Tso, said the following about organized crime in the capital markets:

> "*It is estimated over 90% of fraud cases are not reported, it is difficult to determine exactly how much money is being lost to fraudsters…organized crime is also heavily involved in stock market manipulation and mass market and corporate theft fraud schemes… Corporations that suffer big losses know that with low chances of gaining convictions and having defrauded funds returned, it could be better to keep cases quiet rather than suffer the embarrassment and reputation risk of having a big fraud disclosed in court.*"[26]

[25] "What is snow-washing?" #endsnowwashing. Accessed 17 June 2020.
[26] Cooper, Sam, "'Organized Crime knows fraud is the way to go': firmer RCMP financial crime expert," *Global News*, 8 July 2019.

Although the figure of 90% is staggering, it is also not surprising. Money laundering schemes are inherently difficult to identify by the very nature of being a "secret" that operates outside the bounds of the legitimate economy. Undoubtedly, every criminal carries out his or her actions in hopes of not betting caught, but money launderers operate on the basis of secrecy and anonymity being the crime itself, making them that much harder to find.

D – HISTORY OF MONEY LAUNDERING IN CANADA'S CAPITAL MARKETS

Despite how elusive money launderers may be, there is still an amplitude of research and analysis from various sources that helps us understand this underground economy. Money laundering investigations, and the AML regimes in place, have historically been targeted towards identifying the source of illicit funds (i.e. the crime) and attempting to infiltrate the operation at the placement stage. As described above, regulators appear to be shifting their focus towards sectors at risk of ongoing layering and integration, such as the capital markets. The next section of this paper attempts to analyze the available statistics and case law around money laundering in Canada's capital markets.

D-1 – Historical Data and Statistics

As pointed out in the 2016 FATF report, securities dealers recognize and acknowledge the risks of the securities sector, but they apparently underestimate the degree of vulnerability to money laundering risks.[27] Organized crime and money laundering expert, Stephen Schneider, has cited evidence of the capital markets playing victim to

[27] "Canada's measures to combat money laundering and terrorist financing," *FATF*, 2016. (page 81)

organized crime as early as the 1950s, at which time intimidation tactics were used to gain insider information from brokers.[28] Fast forward to 2002, in response to allegations of a motorcycle gang manipulating the price of a stock, the OSC made a public statement that "criminal groups are laundering funds, manipulating prices, and conducting insider trades through the country's junior markets."[29] The study conducted by Schneider in 2004 identified 7.4% of cases in which the capital markets were the method of operation for money launderers.[30] Schneider went on to explain how there are generally two ways in which bad actors can achieve their money laundering goals through securities:

1. *"The first and most common technique is to purchase stocks and bonds with criminal proceeds, which satisfies the premier objective of the laundering process: converting cash into an alternative asset. Transacting in securities incorporates an added attraction to the launderer in that the alternative asset is highly liquid.*

2. *Instead of purchasing securities, a criminal enterprise may take the opposite route to launder their illicit proceeds: offering shares in a public company previously injected with criminal proceeds, which allows a criminal organization the opportunity to raise capital and thus a seemingly legitimate source of funds. Under this method, a private company is incorporated or an existing one is bought by a criminal organization. The company may not carry out any legitimate business but can appear to be highly profitable through the injections of the proceeds of crime,*

[28] Schneider, Stephen, "Money Laundering in Canada: An Analysis of RCMP Cases," *Nathonson Centre for the Study of Organized Crime and Corruption*, March 2004. (page 53)
[29] Ibid.
[30] Ibid.

which are made to appear as the legitimate revenue of the company. Shares are then issued to the public, preferably through a reputable stock exchange and in conjunction with a respectable under-writer. The actual laundering occurs after shares are purchased by the public and the "capital financing" is received by the original criminal owners of the company."[31]

Having these two alternatives clearly laid out would suggest a potential framework for regulators to reference in detection and prosecution of money launderers attempting to conceal illicit funds through the capital markets. However, Canada's track record is far from positive. According to data gathered from Statistics Canada from 2000 to 2016, there were 321 guilty verdicts in money laundering cases while another 809 were either stayed, withdrawn, or dismissed – a conviction rate of 27%, compared to the UK and the US which have reported money laundering conviction rates of 50% and 85%, respectively.[32] Canada has evidently fallen behind in the race to catch up with money launderers and eliminate the dirty cash from our economy. This naturally begs the next question, if Canada's total conviction rate for all money laundering cases is only 27%, what proportion of that, if any, are securities related convictions?

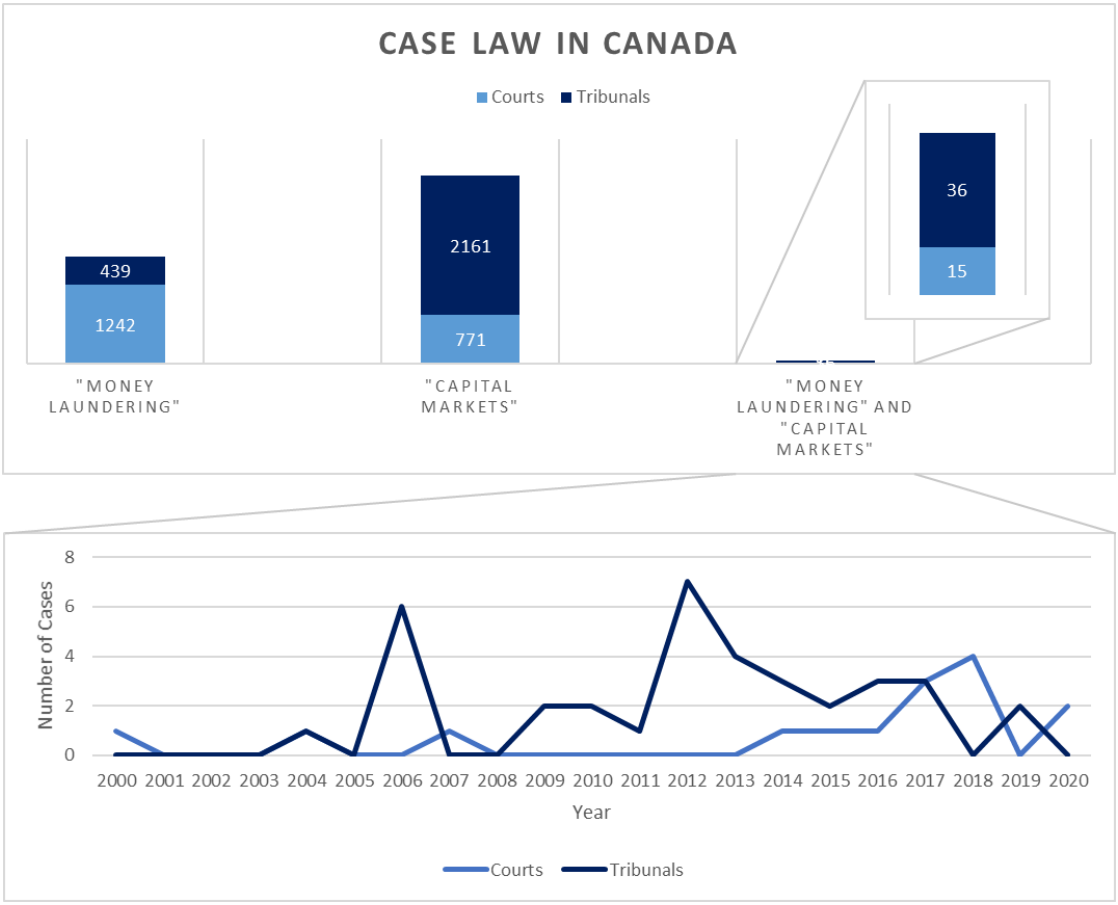
D-2 – Case Law in Canada

A simple quantitative review of available case law in Canada depicts an interesting history of decisions that involved money laundering, capital markets, and a crossover between the two. **Table 6** below was created with the data from CanLII search engine

[31] Ibid. (page 54-56)
[32] Russell, Andrew, "Not just B.C.: Most provinces in Canada fail to secure convictions in money-laundering cases," *Global News*, 10 February 2019.

results. As seen in the top graph, of the roughly 1,700 cases in Canada that made reference to money laundering, the vast majority of decisions were court cases. Conversely, of the approximately 3000 cases involving capital markets, the majority of decisions came from the tribunal level. This inverted ratio between money laundering and capital markets is not a surprise when each issue is considered separately as the issues align with their respective authorities; money laundering is a criminal matter whereas a violation of securities law is an administrative matter. However, we can see that the overlap of both issues is almost non-existent at 51 cases.

Table 6 – Money Laundering and Capital Markets Case Law



Source: CanLII Search Engine Results

"Money Laundering" search results for full date range available from 1987 to date "Capital Markets" search results for full date range available from 1966 to date "Money Laundering" and "Capital Markets" combined search results for full date range available from 2000 to date

When the 51 overlapping cases are expressed over time, as seen in the bottom graph, there is no discernible pattern. The number of cases that mention both money laundering and capital markets has not increased or decreased over the span of 20 years. There was a spike of six cases in 2006 and another spike of seven cases in 2012, all of which were at the tribunal level. From 2016 to 2018, there appears to have been a rise in court cases, only to fall again to zero in 2019. In the sections below, we will look more closely at the decisions over the past 5 years in which there appears to be more diversity in the cases.

D-2-1 – Court Cases

From 2015 to date, there have been 11 court cases that mention both money laundering and capital markets, but this does not necessarily mean each case was about money laundering *in the* capital markets. For example, in *R. v. Nielsen* the decision was based on a breach of an order previously issued by the BCSC in which the only mention of money laundering was reference to prior criminal conduct by Nielson, including "conspiracy to commit money laundering".[33] For the purpose of identifying and analyzing case law around snow washing through securities, these

[33] R. v. Nielsen

are considered false positives. After sifting through the 11 cases and eliminating the false positives, we come to *one* instance of a decision from the Ontario Superior Court of Justice in which Canada came *close* to a court case involving money laundering in the capital markets.

In *Yip v. HSBC Holdings*, Yip alleged that HSBC Holdings, among other things, misled investors with respect to representations about compliance with anti-money laundering and anti-terrorist financings laws, resulting in significant loss. The shares of HSBC Holdings were never traded in Canada but Yip was suing HSBC Holdings as a "responsible issuer" under the Ontario Securities Act – which is defined as (a) a reporting issuer, or (b) any other issuer with a real and substantial connection to Ontario, any securities of which are publicly traded. It was ultimately decided that HSBC was not a responsible issuer and the action was dismissed.[34]

D-2-2 – Tribunal Cases

From 2015 to date, there have been 10 tribunal cases that mention both money laundering and capital markets: one disciplinary and nine under securities. The disciplinary case was an IIROC matter in which one of the findings was a failure to comply with AML requirements, including lack of appropriate client documentation and a lack of AML training – this was a narrow finding and not one of the two primary allegations of the case.[35] Although there were AML-related infractions in this case, it was not a case of laundered funds through the capital

[34] Yip v. HSBC Holdings plc
[35] Rutledge (Re)

markets. In terms of the nine other securities cases, as with the selected court cases above, there are several false positives in which a case will mention the term "money laundering" but it bears no weight on the allegations or substance of the case. There was one case with the Mutual Fund Dealers Association ("MFDA") in which the respondent was found to have circumvented the requirement to report large cash transactions to FINTRAC by splitting a $15,000 cash transaction in two.[36] Again, while this was an AML infraction, it is not a case of using Canada's capital markets to clean illicit funds.

D-3 – Summary of Securities-Related Convictions

Aside from the one case in which Canada was ultimately decided not to have jurisdiction, there are effectively *zero* cases in Canada involving a prosecution of money laundering through the capital markets. Given the volume of case law in Canada's history, especially concerning the topics of money laundering and capital markets, zero seems like an unbelievable statistic. Though it may seem over-simplified, this leads to one of two possible conclusions: (1) Canada's capital markets regulation, and our anti-money laundering regime, is entirely effective at deterring money laundering through securities; or (2) the bad actors laundering funds through Canada's capital markets have successfully navigated the regulatory landscape and remain undetected.

In favour of the former, it is possible that the many layers of regulation that would accompany a scheme of snow washing through the capital markets is perceived as high-risk. The money launderer would have to ensure their activities are not caught by any of

[36] Wang (Re)

the many reporting requirements and disclosure obligations of both the securities regulator and FINTRAC. For example, if the bad actor was a client who wanted to invest $50,000 in cash, the portfolio manager would be required to collect and record a significant amount of personal information to meet their KYC obligations, and the firm would be obligated to report suspicious transactions to FINTRAC as a securities dealer. On the other hand, perhaps it is possible for the money launderer to diversify his dirty investment with multiple portfolio managers and firms in a series of small transactions that would fall under the radar, which favours the latter conclusion. To determine the more likely explanation, Canada's regulatory regime is reviewed in greater detail below, including an assessment of how the cost of AML regulation could play a factor.

E – ASSESSMENT OF AML IN CANADA'S CAPITAL MARKETS

In order to understand the potential shortcomings in Canada's AML regime, and how that coincides with the regulation of Canada's capital markets, we must assess the challenges that market participants face in meeting their various compliance obligations. If there are roadblocks or unrealistic expectations that hinder a firm from making the proper disclosures or filing the necessary reports, then there is potentially a problem at the regulatory level that needs to be addressed. In the sections below, we will look at the landscape of AML compliance in Canada.

E-1 – AML Compliance in Canada

Key to the assessment of Canada's AML regime is an understanding of the costs and challenges of compliance. There must be an appropriate balance between the requirements in place to prevent and detect money laundering, versus the cost incurred by

the organizations required to comply. LexisNexis Risk Solutions conducted a study in 2019 of the true cost of AML compliance in the US and Canada. Survey respondents for Canada included 26 banks, investment firms, asset management firms, and insurance firms of various sizes.[37] Key findings from the survey are summarized below based on cost of compliance and other challenges: [emphasis added]

E-1-1 – Cost of Compliance

- The annual cost of AML compliance for Canadian firms is estimated to be **$5.1 billion**
- The average annual compliance spend for small and mid/large Canadian firms is approximately $1.4 million and $14 million, respectively
- The **cost of AML compliance as a percent of total assets is higher for small firms** (up to 0.85%) compared to mid/large firms (up to 0.08%) because of certain overhead investment requirements regardless of scale
- The cost of AML compliance for small firms goes towards labour while mid/large firms in Canada tend to leverage technology[38]

E-1-2 – Other Challenges

- Mid/large Canadian firms rank **regulatory reporting as a key challenge**, which could relate to changes intended to improve alert reviews, monitoring and more timely reporting to authorities

[37] "True Cost of AML Compliance Study: United States and Canada Edition," *LexisNexis Risk Solutions*, 2019 (page 3)
[38] Ibid (page 4 and 5)

- KYC onboarding is a challenge across firms of all sizes largely due to **lack of standardization with required KYC/AML data**; firms often lack a unified view about an individual or business across **various databases**
- Customer **risk profiling is a challenge** for small Canadian institutions and they also leverage compliance technologies less[39]

If regulators simply layered on more rules, more record keeping requirements, more disclosure obligations, the cost of compliance would be overburdensome. Not to mention it may not be feasible to comply with such unrealistic requirements, which would therefore deem the entire AML regime ineffective. The LexisNexis study also revealed an important distinction in firm size and the cost of compliance, and how technology is used – solutions applied for AML must be feasible for every size of firm and the technology cannot be out of reach.

E-2 – Takeaways for Canada

The lack of transparency around beneficial owners of Canada's private companies is a long-standing issue. As early as 2000, a law was passed to direct "banks, securities dealers, life-insurance firms and other financial entities to make reasonable efforts to identify the owners of firms they do business with; left to carry the load, they do their best to collect information on all counterparties, but it is not enough."[40] Canada's market participants were given the reins to determine what "reasonable efforts" entails without any specific direction or tools to ease the process and improve results. This places the burden

[39] Ibid (page 6 and 8)
[40] "Snow-Washing: Canada frets about anonymously owned firms," *The Economist*, 4 January 2018.

entirely on the firms and allows for vast inconsistencies in the approach to determine beneficial ownership, which exposes Canada's capital markets to the vulnerability of money laundering. The lack of consistency or standardization is a weakness because each firm may consider a different level of information to be sufficient in making a reasonable effort to understand the true identify of their clients. Moreover, some firms may be limited in their ability to fulfill KYC requirements to the same degree as others. As noted above, large firms benefit from economies of scale when it comes to accessing technology and other tools that assist in the AML compliance process.

Although market participants and standard setters acknowledge the issue of snow washing, Canada's AML regime has not seen much improvement in the past 20 years. FATF conducted a review of Canada in 2016 and "concluded that only a fraction of the country's 2.5 million legal entities had accuracy checks performed with respect to beneficial ownership."[41] The number of private legal entities in Canada is an astonishing number in and of itself. But consider how many of those entities are investment vehicles for bad actors to clean dirty funds by cashing out on investments, and the impact on Canada's capital markets is potentially significant. Based on the results of the LexisNexis survey, Canada is in need of a low-cost solution to improve our AML efforts that is accessible to market participants of all sizes without far exceeding the existing regulatory requirements. All of which points to the favoured solution that has gained significant traction in recent years: a public registry of beneficial owners.

[41] "Snow-Washing: Canada frets about anonymously owned firms," *The Economist*, 4 January 2018.

F – THE FUTURE OF AML IN CANADA'S CAPITAL MARKETS

Taking account for all of the above, Canada's capital markets are primed and desperately in need of a rapid solution to our money laundering problem. Both regulators and market participants acknowledge that illicit funds are already circulating though the markets, but that does not mean acceptance and complacency are the order of the day. There are already current opportunities what are widely supported and ready for the final seal of approval. There are also opportunities in new technological trends and tools to assist with AML compliance, but naturally the development of technology also brings out certain challenges, namely the introduction of virtual currencies. In addition, Canada and the world are currently in the midst of an economic disturbance unlike anything we have ever experienced with the widespread COVID-19 pandemic. The sections below delve into all of these factors in assessing the future of AML efforts in Canada's capital markets.

F-1 – New Opportunities

The concept of a beneficial ownership registry has been discussed at various points throughout this paper, and how this highly publicized proposal appears the be a simple solution. Directly below, we will further explore the rationale for a beneficial ownership registry as well as some of the opportunities presented by technology such as machine learning and artificial intelligence.

F-1-1 – Beneficial Ownership Registry

To recap, some of the key challenges of AML compliance in Canada were identified in the LexisNexis survey as regulatory reporting and lack of

standardization of required KYC data, with inconsistencies across various databases. In addition, smaller firms do not benefit from the same access to technologies as the large firms as they are restricted by cost. In response to the question "What can be done to address snow-washing?", The Coalition behind #endsnowwashing summarized this statement:

> "*The federal government should create a pan-Canadian company register of beneficial owners that is publicly accessible, centralized, and searchable and employs leading international best practices such as ID verification, a tip-line for whistleblowers, and a registrar with powers to issue penalties*."[42]

In April 2019, there was an amendment to the Canada Business Corporations Act which now requires companies to disclose beneficial ownership information, but the information still isn't made widely available.[43] The Coalition further explained their rationale for the implementation of a publicly available beneficial ownership registry in a statement citing how the Expert Panel from the Cullen Commission said "enhanced beneficial ownership disclosure is the single most important regulatory improvement opportunity available," and that any beneficial ownership registry in Canada should be "transparent, public and easily accessible, consistent with best practices."[44]

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[42] "What is snow-washing?" #*endsnowwashing*. Accessed 17 June 2020.
[43] Sztanek, Victoria, "Eyes on Vancouver: Money Laundering in Canada," *ACAMS Today*, 26 December 2019.
[44] "Rationale for A Publicly Accessible, Pan-Canadian Company Registry Of Beneficial Owners To Address The Proceeds Of Crime Through Anonymous Companies," #endsnowwashing. Accessed 20 June 2020.

A centralized registry eliminates the issues around various databases housing inconsistent information. By having all the information in one place, there can be quality controls implemented to ensure all the information available from the database is standardized. The public aspect of the registry also removes the accessibility issue as smaller market participants would not have to worry about incurring outlays of additional funds to access the same information as the larger firms in fulfilling the same KYC obligations. In their rationale statement, The Coalition went on to specify the specific attributes that would be desirable for an effective public registry, included in **Table 7** below.

Table 7 – Attributes for an Effective Public Registry[45]

To set up an effective publicly accessible registry, Canada should follow the below recommendations noted in Publish What You Pay Canada's (PWYP) policy note, *Building a Transparent, Effective Beneficial Ownership Registry: Lessons Learned and Emerging Best Practices from Other Jurisdictions:*

1. The registry needs to focus on entities and arrangements that are the most opaque, i.e. non-distributing (or privately held) corporations, partnerships, and other legal entities not subject to securities regulation.
2. The registry needs to provide access for all users including those with statutory due diligence obligations.
3. Information submitted by companies – including identification—should be verified by a registrar to ensure its integrity.
4. The registry should require prompt updates once company information changes.
5. The database should have searchable fields with drop-down menus and unique identifiers for each submission in order to root out inconsistencies with data entry, and to facilitate searching and recalling records.

Evidently, there is significant support for this initiative, and standard-setters have taken notice. The campaign timeline tracked by The Coalition covers many of the key milestones in Canada's recent history around improving transparency, summarized as follows:

[45] Ibid.

December 2017	*Canada's Federal Government, Provinces, and Territories create an Agreement To Strengthen Beneficial Ownership Transparency*
December 2018	*Canada passes legislation (Bill C-86) requiring federally-incorporated businesses to keep and maintain a registry of individuals with significant control*
April 2019	*British Columbia passes Land Owner Transparency Act which requires property owners to publicly disclose beneficial ownership information*
June 2019	*Stakeholder consultations announced to examine benefits of public beneficial ownership registry, Federal requirements for federally-incorporated businesses to keep a registry for individuals with significant control come into effect*
October 2019	*Quebec announces consultations to strengthen corporate transparency*
December 2019	*Federal, provincial, and territorial finance ministers re-affirm consultations for public beneficial ownership registry*
January 2020	*British Columbia announces consultations to evaluate public registry of beneficial ownership information*

February 2020	*Federal Government initiates consultations to evaluate public registry of beneficial ownership information*
March 2020	*Quebec announces that it will make beneficial ownership information publicly available*[46]

In summary, a publicly available registry of beneficial ownership not only seems to be a favoured and feasible solution, but also entirely necessary in support of Canada's AML efforts in the scope of the capital markets. Securities legislation sets out the requirements for market participants to identify their clients in complying with their KYC obligations, and in turn the firms' AML compliance obligations. A public registry would be a simple solution to meeting those obligations in a consistent manner across the market and represent a huge step forward in Canada's efforts to combat money laundering through securities by shedding a spotlight on the bad actors. Going forward, the registry may act as a deterrent or a preventive measure in Canada's AML regime, but in the meantime, it would also expose and weed out the criminals who are already operating in our legitimate economy.

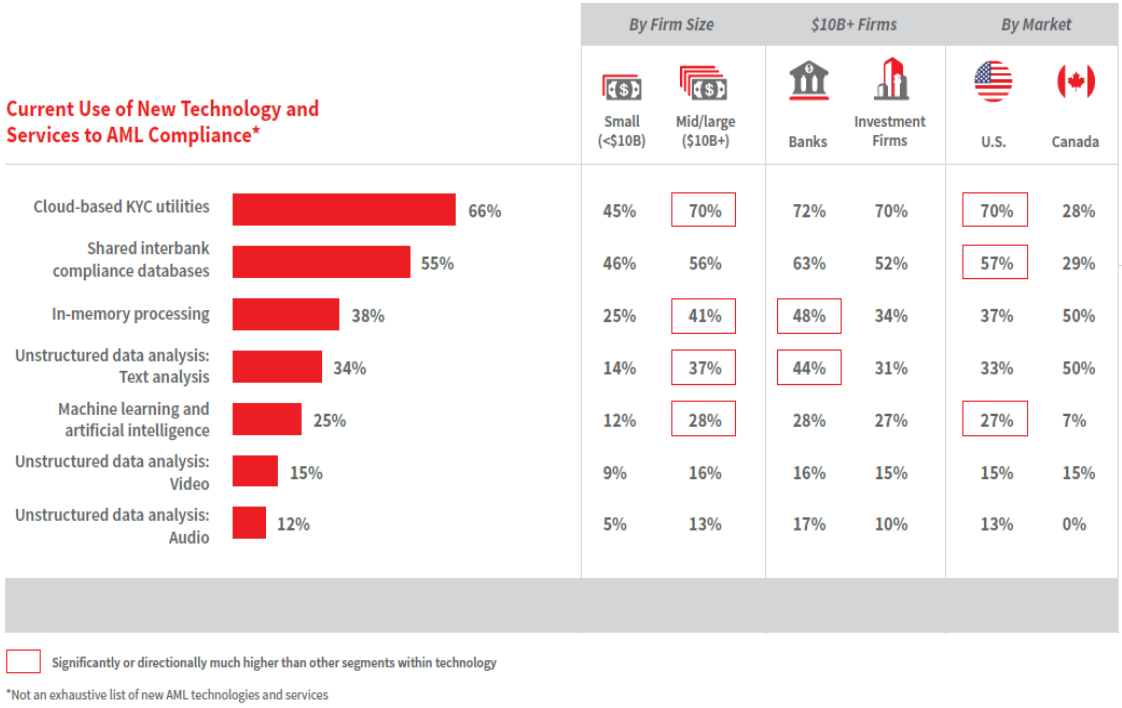
F-1-2 – New Technologies and Artificial Intelligence

Compared to the US, firms and institutions in Canada appear to be relying on "old technologies" for AML compliance. The LexisNexis survey on the cost of AML compliance revealed how Canada ranks in the current use of technologies and services, but also to what degree Canadian firms expect certain technologies to

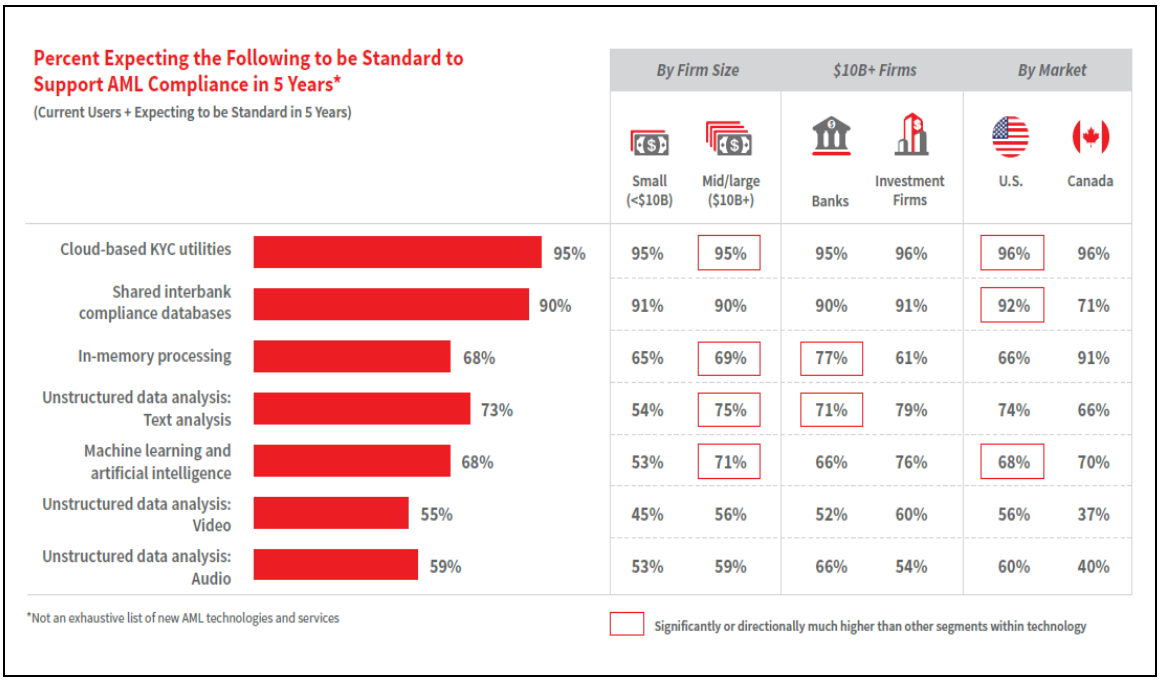
[46] "Campaign Timeline," #*endsnowwashing*. Accessed 17 June 2020.

be standard within five years. As depicted in the top chart of **Table 8** below, Canada appears to fall far behind the US when it comes to cloud-based KYC utilities, shared interbank compliance databases, and the use of machine learning and artificial intelligence. However, 50% of Canadian firms use in-memory processing and unstructured text analysis. By contrast to the bottom chart in the **Table 8** below, upwards of 70% of firms believe cloud-based KYC utilities, shared interbank compliance databases, and the use of machine learning and artificial intelligence will be a standard necessity for AML compliance within five years.

Table 8 – LexisNexis Survey Results: Use of AML Technologies and Services[47]



[47] "True Cost of AML Compliance Study: United States and Canada Edition," *LexisNexis Risk Solutions*, 2019 (page 11 and 12)



The results of the survey suggest that Canadian firms acknowledge how new technologies and artificial intelligence will undoubtedly benefit AML compliance efforts, and yet it seems that Canada has a long way to go. Where Canada's heavy use of in-memory processing and text analysis may have been cutting edge at some time, those technologies are quickly being overrun by the adaptive learning capacity of machine learning and artificial intelligence. As the world moves quickly and technologies change, particularly in the capital markets with the rapid introduction of virtual currencies, Canada's AML regime needs to keep pace, and regulators are acknowledging this.

FINTRAC recently reported that they are exploring the use of artificial intelligence and machine learning to improve how they sort through droves of information around Canada's illegitimate economy. In their 2018-2019 annual report, FINTRAC acknowledged that these advances in technology are both

opportunities and challenges, stating that "technology enables quickly morphing threat vectors but can also create new ways of doing business that are more efficient and effective, as well as reduce burden and costs for businesses."[48] Similarly, the most recent Enforcement Report from the CSA, titled "Evolving Securities Enforcement for a Digital World", emphasizes how securities regulators are leveraging technology. The report cites how various CSA jurisdictions are "embracing new skills and roles. Data scientists, analysts and blockchain specialists are among the new roles joining investigators and lawyers in the fight to protect investors."[49] Evidently, as criminals develop new skill sets, regulators have acknowledged the need to keep pace.

It is encouraging to see that both regulators and market participants are on the same page when it comes to the trajectory of technology in the effort to improve Canada's AML regime. However, the idea is only as good as the execution of that idea, no matter how optimistic. Canada has a reputation for taking all the time necessary to contemplate any significant changes to the status quo, but perhaps the speed at which the world is evolving will force our hand to embrace new technologies and artificial intelligence sooner rather than later. It will certainly be necessary to confront the potential challenges that are likely to expose Canada's capital markets to further money laundering risks, which are discussed in the next section of this report.

[48] "FINTRAC Annual Report 2018-2019," *FINTRAC*. Accessed 19 June 2020. (page 32)
[49] "Evolving Securities Enforcement for a Digital World: FY 2018/19 Enforcement Report," *CSA*. Accessed 19 June 2020. (page 11)

F-2 – New Challenges

There are already obvious complications in the detection of money laundering schemes, mostly around the ability to trace the funds back to criminal origins. The introduction of external factors such as rapidly advancing technologies and economic volatility expose every sector – securities, real estate, gambling, and more – to additional hurdles in the battle against this illegitimate economy. However, there are two areas in particular that may pose new challenges related to the threat of money laundering through the capital markets in Canada: virtual currencies and the impact of COVID-19.

F-2-1 – Virtual Currencies

There are certainly fears around all transactions being anonymized and untraceable in the world of cryptocurrencies, creating a virtual myriad of complications when it comes to regulatory compliance in the capital markets and the ability to trace laundered funds. But there is also the argument that every transaction is recorded and available to the public on the blockchain, and with the right technology, it is possible to trace the initial source of funds. Elliptic, an organization which focuses on the disruption of illicit activity in cryptocurrencies, supports this argument as they make the comparison to traditional cash transactions which, by contrast, are completely devoid of any paper (or electronic) trail.[50] Regardless of the viewpoint, virtual currencies certainly introduce a new avenue

[50] Robinson, Tom (Elliptic), "Crypto can prevent money laundering better than traditional finance," *VentureBeat*, 20 July 2019.

for money launderers to experiment with the transparency of their illegal transactions.

One of the ways virtual currencies pose a new challenge to Canadian regulators is the introduction of Bitcoin ATMs. These operate just like the typical bank ATM, but instead of depositing cash into a bank account, the cash is converted to Bitcoin and assigned to a wallet. For the oversight of Canada's anti-money laundering regime and capital markets, this raises two primary concerns with respect to the detection of illicit funds. First, unless there is surveillance in place, the individual who deposited the cash is a ghost. The anonymity factor is evidently sold as a major upside to the user since "a chain of Bitcoin ATMs with machines in eight provinces advertises: "No ID is needed" and "our ATMs are 100% anonymous"."[51] Second, all the cash in the Bitcoin ATM is comingled from various sources, both legitimate and potentially criminal. Even though the cash will likely be placed in the banking system eventually, it would be impossible to separate the illicit funds.

Bitcoin ATMs may sound like a novel idea but there is a surprising volume scattered across the country. "According to Coin ATM Radar, a website tracking cryptocurrency ATMs, there are 718 Bitcoin ATMs in Canada, second only to the United States in world distribution."[52] Adrian Humphreys, a senior investigative reporter at *National Post*, outlined a very simple scenario of how a network of

[51] Humphreys, Adrian, "The underworld laundromat: How to clean $10 million in mob money," *National Post*, 5 December 2019.
[52] Ibid.

money launderers can achieve their placement goal using a Bitcoin ATM, as outlined in the example below:

> "*We can deposit as many bills as we want in as many ATMs as we like…Let's push 180 $50 bills and 300 $20 bills into two machines twice on a slow night and send four associates to do the same for us twice the next day. Minus a service fee of 12%, we shed $320,000 of small, awkward bills and get $281,600 of pretty anonymous Bitcoin."*[53]

The key takeaway from this example is how, for a nominal cost and almost no risk, the offenders have successfully washed their hands of the dirty cash. The network of "associates" also highlights another tracing-related issue – even if it were possible to trace the wallet to a specific person, there is no guarantee that the depositor and the wallet owner are the same person.

Another crypto challenge posed to regulators is the introduction of Bitcoin mixers. Bitcoin Magazine outlines the following definition: "Bitcoin mixers are solutions (software or services) that let users mix their coins with other users, in order to preserve their privacy."[54] This potentially takes the layering aspect of the money laundering cycle to an entirely different level. Where in the past the comingling of legitimate and illicit funds was a biproduct of funds being placed into the financial system, bitcoin mixers *purposely* layer the potentially illegal

[53] Ibid.
[54] "What are Bitcoin Mixers?" *Bitcoin Magazine*. Accessed 7 June 2020.

source of funds. While this is touted as a benefit to the average person seeking to protect their privacy, it also masks criminal identity.

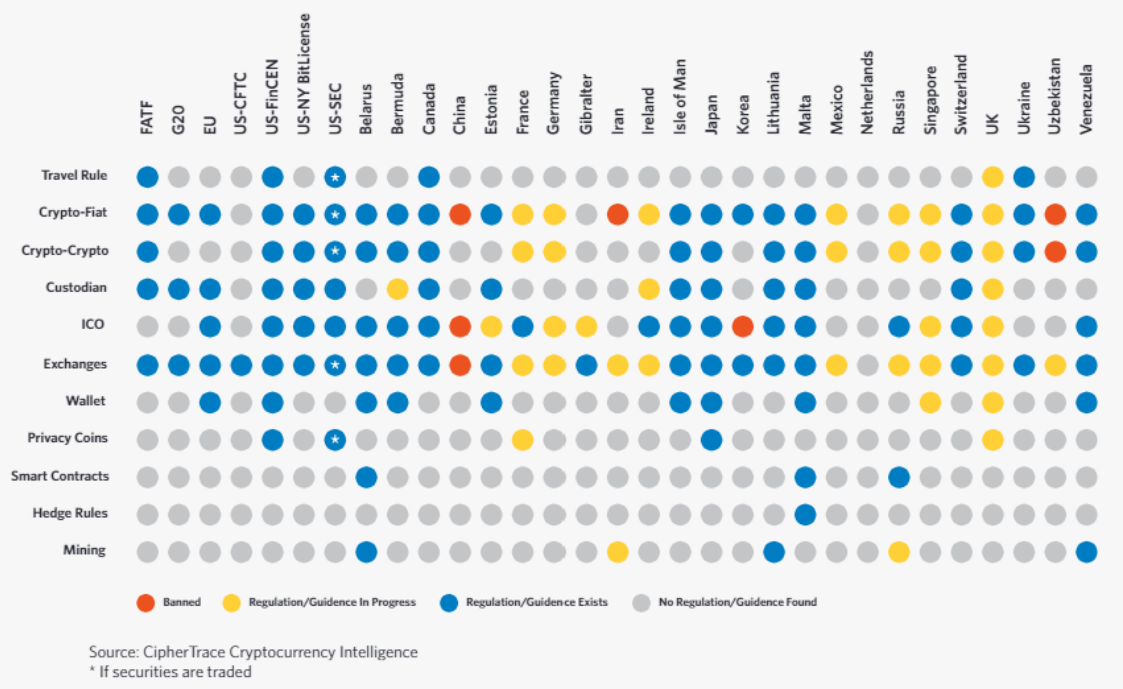
Bitcoin ATMs and mixers appear to be an incredibly attractive opportunity for laundering illicit funds in a clean and seemingly risk-free way. The use of virtual currencies like Bitcoin may grow to become a "fan-favourite" amongst money launderers in the future, but for now this concept still appears to be in the infancy stage. It is estimated by the United Nations that roughly $800 billion to $2 trillion USD is laundered globally in just one year.[55] The blockchain forensics and cryptocurrency intelligence organization, CipherTrace, estimates that the total losses globally in 2019 resulting from the use of cryptocurrency as an avenue for fraud and misappropriation of funds amounts to $4.15 billion USD.[56] Elliptic conducted their own analysis in the first half of 2019 which found that $829 million worth of Bitcoin was spent on the dark web.[57] While there is clearly a wide range in the estimate of funds laundered on the blockchain, this suggests that the global risk of money laundering through cryptocurrency is potentially less than 1%.

Given the inherent nature of how a money laundering scheme operates, it is extremely difficult to pinpoint a single value or even confirm whether an estimate is truly representative of the actual figure. This is true for transactions both on and off the blockchain – bad actors don't exactly keep books and records that they willingly share with the general public to support our data interests.

[55] "Money-Laundering and Globalization," *United Nations: Office on Drugs and Crime*. Accessed 24 May 2020.
[56] "Cryptocurrency Anti-Money Laundering Report, 2019 Q4," *CipherTrace*, January 2020. (p. 5)
[57] Robinson, Tom (Elliptic), "Crypto can prevent money laundering better than traditional finance," *VentureBeat*, 20 July 2019.

Notwithstanding, regulators around the world have acknowledged the money laundering risks posed by cryptocurrencies and have implemented legislation to varying degrees. **Table 9** below from CipherTrace depicts the current implementation of AML regulations around the world.[58] Several countries are still developing regulations or guidance, while a handful have enforced outright bans. Canada has implemented regulations around several areas of cryptocurrency but there are gaps around wallets, privacy coins, smart contracts, hedge rules, and mining.

Table 9 – Current Implementation of Crypto-Related AML Regulations



[58] "Cryptocurrency Anti-Money Laundering Report, 2019 Q4," *CipherTrace*, January 2020. (p. 20)

Much of the Canadian guidance around cryptocurrencies in the capital markets can be found in various Staff Notices issued by the CSA, including:

- CSA Staff Notice 46-307 *Cryptocurrency Offerings*[59]
- CSA Staff Notice 46-308 *Securities Law Implications for Offerings of Tokens*[60]
- CSA Staff Notice 21-327 *Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto Assets*[61]

Each of these CSA Staff Notices builds on each other as a framework which focuses on the application of securities legislation in Canada with respect to virtual currencies and crypto assets. While this framework includes registration requirements and various disclosure obligations, it does not cover the specific risks or reporting requirements associated with anti-money laundering. As described above, the oversight and enforcement of Canada's anti-money laundering regime is not within the mandate of the CSA or any of the individual provincial securities regulators, rather that responsibility falls to FINTRAC. In June 2014, Canada was the first country to pass legislation around cryptocurrency, with specific application under the anti-money laundering regime, summarized as follows:

> *"The law treats virtual currencies, including Bitcoin, as 'money service businesses' for purposes of anti-money laundering laws. As*

[59] "CSA Staff Notice 46-307 Cryptocurrency Offerings," *Ontario Securities Commission*, 24 August 2017.
[60] "CSA Staff Notice 46-308 Securities Law Implications for Offerings of Tokens," *Ontario Securities Commission*, 11 June 2018.
[61] "CSA Staff Notice 21-327 Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto Assets," *Ontario Securities Commission*, 16 January 2020.

a result of the law, companies dealing in virtual currencies are required to register with [FINTRAC], put into effect compliance programs, retain prescribed records, report suspicious or terrorist-related property transactions…The law will also apply to virtual currency exchanges operating outside of Canada who direct services at persons or entities in Canada."[62]

Cryptocurrencies have undoubtedly introduced a new set of risks and compliance concerns around money laundering, particularly in the world of securities regulation. FINTRAC has already seen a significant rise in number of referrals to regulators and law-enforcement agencies linked to cryptocurrency incidents – a jump from 19 to 61 referrals between 2018 and 2019.[63] The collective oversight required by all regulators was summarized well by the Bank of Canada: "Regulators need to examine crypto assets from a number of angles: the potential risks to the stability of the financial system, the integrity of markets and protection of investors, and protection against abusive financial flows such as money laundering…"[64] While the CSA continues to adopt new guidance on crypto for the capital markets, and FINTRAC continues to expand the reporting requirements as part of Canada's anti-money laundering regime, these two regulatory bodies may soon have to work more closely together if virtual currencies expand as a popular scheme for money laundering in Canada's capital markets.

[62] "Regulation of Cryptocurrency: Canada," *Library of Congress: Law*, 16 August 2019.
[63] Posadzki, Alexandra, "Anti-money-laundering watchdog sees increase in reports linking bitcoin to sex trade trafficking," *The Globe and Mail*, 15 December 2019.
[64] Lane, Timothy, "Decrypting Crypto," *Bank of Canada*, 1 October 2018.

F-2-2 – Impact of COVID-19

The global COVID-19 pandemic is still in the early stages of research and evaluation from every perspective – medical, psycho-social, financial, and so on. While it may be too soon to understand the total impact that the pandemic will have on the Canadian economy, many significant changes have already become the "new normal" and could have an interesting impact on money laundering. For instance, in an effort to prevent the spread of the virus, many businesses that stayed open have enforced a strict no-cash policy. Although for some smaller establishments where cash is necessary, the practice of quite literally "washing" cash[65] has presented an ironic parallel to some money laundering comics featuring a bad actor running cash through a washing machine – the illustration in **Table 10** below has a distinctively Canadian angle.

Table 10 – "Canadian Real Estate" by Greg Perry[66]

[65] Trinh, Brian, "Canadian Money Laundering Gets Hilarious Twist During COVID-19 Pandemic," *Huffington Post*, 31 March 2020.
[66] Perry, Greg, "Canadian Real Estate", *The Tyee*, 16 May 2019.

Not to digress, the general reduction in the use of cash could result in serious constraints for money launderers attempting to hide their illegal activities – it would be hard to fall under the radar while still relying on cash as the rest of the country and the world moves towards a greater use of electronic payments. Data collected over the course of the COVID-19 pandemic in Canada shows a rise in first-time e-transfer payments of 62% compared to the prior year.[67] Although this figure seems significant, it is important to remember that this pattern arose out of a forced situation and does not necessarily represent a reduced appetite for using cash. This pattern could be overturned, reduced, or continued in the post-pandemic phase. Meanwhile, it is interesting to consider how this new aversion to cash impacts money laundering in Canada and there are really two alternatives: (1) money laundering significantly declines, or (2) money laundering continues in new ways.

In the first alternative, consider the broad situation in a pandemic state – small cash-heavy businesses like dry cleaners are temporarily closed, real estate markets are in flux, casinos are deemed non-essential and forced to shut-down – do we therefore conclude that money laundering in Canada has also (temporarily) closed for business? In an ideal world, we would have some sort of data around the underworld cash flows of money launderers to assess whether the significant reduction in cash transactions, coupled with economic shutdown, cuts off the bad actors and prevents money laundering from occurring. Sure, the proceeds of crime may still exist, but there would be added risk and fewer avenues to attempt to place and layer the cash in the legitimate economy, especially in large amounts and large

[67] Lorinc, John, "Will Canada go cashless post-pandemic?" *Maclean's*, 29 April 2020.

bills. Harvard professor and former chief economist of the IMF, Kenneth Rogoff, acknowledged this in his book *The Curse of Cash* in which he "argues that eliminating $50 and $100 bills would undermine counterfeiting, money laundering, terrorist financing, human trafficking and tax evasion."[68] Absent the definitive knowledge of what money launderers are truly up to in Canada during the pandemic, we can only assume that a reduction in cash *should* logically infer a reduction in money laundering.

In the second alternative, we entertain the idea that money launderers are not so straightforward in their approach. Perhaps the pressure to clean up their dirty cash would have these criminals rise to the challenge and adapt new ways to keep the illegitimate economy moving – whether through experimentation with virtual currencies, investing in our capital markets, or otherwise. In an opinion piece contributed to The Globe and Mail, Joy Thomas, President and CEO of CPA Canada said:

> "*International bodies are sounding the alarm on the increased risks of fraud, money laundering and other financial wrongdoing because of the pandemic and the related economic stimulus measures. The heightened risk of financial crimes makes it even more important to not lose focus on governments' efforts to tackle money laundering in Canada. Information on who owns, controls or ultimately benefits*

[68] MacLeod, Meredith, "Are Canadians ready to go cashless after coronavirus?" *CTV News*, 5 June 2020.

from any privately held corporation involved in potentially illegal activities is critical to uncovering and fighting financial crimes."[69]

Some might argue cash is no longer king in a COVID-19 economy, or the foreseeable future, but that isn't necessarily a deterrent for criminals who need to keep funds moving. Rather, while the world is preoccupied with the health and safety concerns arising from the pandemic and the legitimate global economy is flustering, the underground economy takes advantage of the chaos and hides deeper in the shadows. Hence the warning from Thomas to not get caught in the tunnel vision of COVID-19 and to forge ahead with important changes that will strengthen Canada's anti-money laundering regime; namely, the implementation of a public registry of beneficial owners.

We have already seen the impact of delays caused by the pandemic with the new law in British Columbia around transparency of corporate ownership delayed from May to October.[70] With respect to Canada's provincial securities regulators, this is potentially just the first example of how COVID-19 may interfere with regulators' ability to detect potential money laundering in the capital markets. In the meantime, FINTRAC has adjusted operations by releasing pandemic guidelines to ensure suspicious transaction reports remain a priority.[71]

[69] Thomas, Joy (CPA Canada), "Opinion: Pandemic reinforces the need for corporate transparency to fight money laundering," *The Globe and Mail*, 2 June 2020.
[70] Hoekstra, Gordon, "COVID-19: Some delay in anti-money-laundering measures because of pandemic, but progress being made," *Vancouver Sun*, 3 May 2020.
[71] Humphreys, Adrian, "Canada's money-laundering monitor now triaging reporting process by COVID-19-hit businesses," *National Post*, 26 March 2020.

G – CONCLUSION

Canada has undoubtedly had a shaky history when it comes to controlling money laundering in the capital markets. After exploring and evaluating Canada's anti-money laundering efforts and the relevant securities legislation that governs our capital markets, it is clear to see that there is significant oversight in place but there are aspects that need improvement. In particular, Canada's lack of transparency around beneficial ownership is a significant problem for snow washing through securities, but also for Canada's money laundering problem at large. So long as money launderers feel safe in their anonymity within Canadian borders, our markets will remain vulnerable to criminals seeking a safe spot to clean their dirty funds.

The statistical analysis and case law review demonstrates how difficult it is to estimate the nature and extent of money laundering in Canada's capital markets, and we have explored multiple examples of how easy it is for money launderers to use the capital markets as the method of operation in their criminal endeavours. With securities having such a significant risk level, and yet a very low conviction rate, Canada needs to allocate the appropriate resources to strengthening our ability to combat money laundering in this form. Multiple reviews and assessments of Canada's regulatory landscape by various organization have pointed out that we have the AML structure, and we have our capital markets regulators, but where we need improvement is at the disclosure level.

The cost of compliance survey revealed how market participants are already incurring significant costs in the implementation of their AML compliance programs, but the key challenge is having access to the right information in a standardized format that

allows firms of all sizes to fulfill their KYC obligations equally. The lack of consistency or standardization is a weakness because each firm may consider a different level of information to be sufficient in making a reasonable effort to understand the true identify of their clients. Moreover, some firms may be limited in their ability to fulfill KYC requirements to the same degree as others. As noted above, large firms benefit from economies of scale when it comes to accessing technology and other tools that assist in the AML compliance process.

While technological advancements and the introduction of artificial intelligence certainly presents an attractive tool to assist market participants in their AML compliance efforts, the key seems to be *access to consistent, reliable information* rather than complex tools to obtain such information. The introduction of a publicly available registry of beneficial owners is undoubtedly the favoured solution to address this both in the capital markets, and for Canada's overall AML regime. A centralized registry eliminates the issues around various databases housing inconsistent information. By having all the information in one place, there can be quality controls implemented to ensure all the information available from the database is standardized. The public aspect of the registry also removes the accessibility issue as smaller market participants would not have to worry about spending additional funds to access the same information as the larger firms in fulfilling the same KYC obligations.

Canada's capital markets are diverse and constantly adapting to change. We see that now in the era of virtual currencies and dealing with the impacts of a pandemic economy. The simple solution of a public database may be all we need to plough through the national issue of snow washing through securities.

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