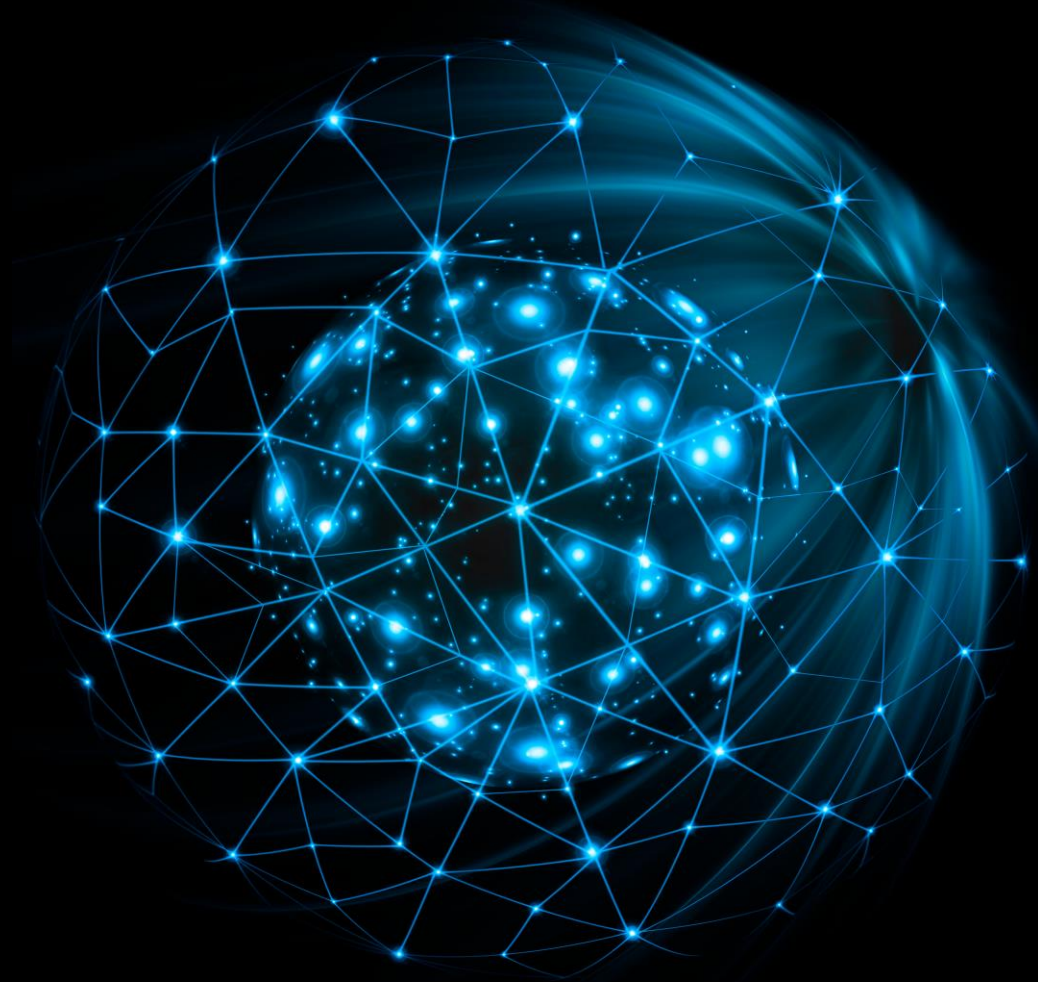


**Deloitte.**



A holistic surveillance approach to address money laundering (ML) risks in financial markets

In our series of articles on misconduct surveillance in financial markets, we address key factors in the regulatory environment, emerging technology solutions, industry best practice and vulnerabilities pertaining to trade surveillance.

In this article, we focus on the synergies between market abuse surveillance and anti-money laundering (AML) functions and on the value of assessing and mitigating the overall exposure to economic crime in financial markets by integrating the two frameworks and their related processes and data.



# 1. The regulatory trend towards holistic trade surveillance

In recent years, regulators have increased their focus on further strengthening frameworks to combat market abuse and provide greater investor protection, highlighted by the implementation of the EU Market Abuse Regulation (MAR) in 2016 and the Market in Financial Instruments Directive (MiFID II) in 2018. MAR came into force jointly with Directive 2014/57/EU on criminal sanctions for market abuse (CSMAD), providing minimum harmonisation of criminal liability for market abuse and more severe regulatory sanctions.



## 1.1. The Swiss market

The Swiss financial services industry is subject to the EU market abuse regime that, due to its extra-territorial application, is relevant for all financial institutions with operations in Europe. Under MAR, compliance requirements are significantly extended to cover financial instruments trading not only on EU regulated markets but also on multilateral trading facilities (MTFs) and organised trading facilities (OTFs).

The Swiss regulatory framework was brought into line with international standards with the implementation of the Financial Market Infrastructure Act (FMIA) and Ordinance (FMIO) in 2016. FINMA monitors market integrity and sanctions violations by all market participants, including legal entities as well as individual participants, regardless of whether or not they are subject to prudential supervision.

The Swiss financial services industry is therefore required to implement effective and comprehensive trade surveillance frameworks to mitigate market conduct risk and prevent the need for regulatory action. As highlighted in Deloitte's 2018 article "[Complying With Market Abuse Regulation: Time to prioritise quality over quantity?](#)", market participants will be better equipped to respond to the increased regulatory requirements by ensuring that the trade surveillance function addresses the firm's specific market activities and related risks, and deploys effective monitoring systems.



## 1.2. The added value of holistic surveillance in meeting regulatory requirements

We observed that market participants are responding to these heightened regulatory expectations by making significant investments in misconduct detection and improving their capabilities in trade surveillance. In particular, a growing trend among leading institutions is to combine signals from different data sources to better detect trading misbehaviours.

# 1. The regulatory trend towards holistic trade surveillance

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Our view is that effectiveness can be improved with the adoption of this more holistic approach to trade surveillance. The integration of a broader combination of data points from both trading activities (such as trading strategies, asset classes, financial instruments, service models and trading venues) and trader communications (such as social media, chats, e-mails and voice communications) results in enhanced reactive and preventive functionality of the trade surveillance system.

For instance, in a case of insider trading, a trader acts on unpublished price-sensitive information and the resulting trading activity occurs before the news is made public and thus discounted by the market. The subsequent dissemination of material information will result in a profit originated by the unfair advantage that the trader had over the market. In this case, the trading activity alone is not sufficient to evidence misconduct but must be assessed together with existing trader communication records. For example recordings of telephone conversations, emails, social media postings of traders sharing or receiving insider information can constitute crucial, and sometimes the only, evidence to prove intent and thus detect the instance of insider dealing. Signals from such records must therefore be interpreted jointly with the actual trading activity to detect red flags for market abuse behaviour.

We believe therefore that a holistic approach can achieve significant gains in both efficiency and effectiveness, by producing fewer, but more accurate alerts for misconduct identification, while also improving the detection of new and evolving risky trading behaviours and hidden networks.

## 2. Synergies between the market abuse and AML frameworks

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Regulators such as the Financial Conduct Authority (FCA) in the UK and intergovernmental agencies such as the Financial Action Task Force (FATF) have increased their scrutiny of exposures in the financial markets to money laundering risk, and they have recognised the potential correlation between market abuse and money laundering.

In 2017, a UK National Risk Assessment of money laundering and terrorist financing concluded that capital markets were exposed to high risks of money laundering. In 2018, the FATF published guidance for a risk-based approach (RBA) for the securities sector<sup>1</sup>: This suggests that market abuse risk is relevant in the AML context for two principal reasons. Firstly, some forms of market abuse may constitute an offence of money laundering under applicable national laws. Secondly, certain controls implemented to comply with market abuse regulations, particularly the surveillance of trading activity, may be useful in monitoring for suspicious activity for AML purposes.

We believe that efficiency gains and better management of the overall exposure to misconduct can be achieved through a closer alignment between the market abuse and AML frameworks within the trade surveillance function.

In addition to the broad territorial scope of several regulations, the increased level of scrutiny, collaboration and sharing of lessons learned among regulators from different jurisdictions require financial institutions to ensure a robust and comprehensive trading surveillance function. As illustrated by two case studies below in section 3, the ability to timely detect and mitigate AML and other risks originating through the trading activities is crucial for avoiding regulatory fines and other actions, and ultimately to manage reputational risk.



### 2.1. Indications from the industry: A thematic review

A thematic review by the FCA<sup>2</sup> in 2019 focused on ML risks pertaining specifically to the trading of financial instruments: it found a potential disconnect in part of the industry between trade surveillance for market abuse and AML transaction monitoring functions. According to the review, some participants were not considering that suspicions of market abuse could potentially be an indicator of money laundering and, consequently, they were not always fully aware of their exposure and vulnerabilities to ML risks in capital markets.

However, the FCA recognised growing synergies between trading surveillance and AML functions, particularly in some larger organisations that had adopted a more coordinated approach for the two functions by including ML red flags and risk indicators in capital markets in their business-wide risk assessment.

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<sup>1</sup> The FATF project group was composed of representatives from FATF members (International Organisation of Securities Commissions (IOSCO), Ireland, Luxembourg, Singapore and the USA) and from the private sector (Association for Financial Markets in Europe (AFME), Pershing, Philip Capital, Royal Bank of Canada, and the Securities Industry and Financial Markets Association (SIFMA)).

<sup>2</sup> The FCA visited 19 participants covering different segments of the market, including investment banks, recognised investment exchanges, trade bodies, a custodian bank, clearing and settlement houses, inter-dealer brokers and trading firms.

## 2. Synergies between the market abuse and AML frameworks

The key findings of the review cover the following focus areas:



### Know Your Customer (KYC) / Customer Due Diligence (CDD)

- Effective customer risk assessment and due diligence, including assessing the clients' intended trading strategies of clients, are key to managing ML vulnerabilities and exposures in the financial markets;
- The nature of transactions in secondary markets, often cross-border and routed through multiple market participants, implies a lack of visibility of the underlying customers of a firm's intermediaries. These interdependencies with other market players further emphasise the importance of sound CDD practices within each firm in the transaction chain;



### Transaction monitoring

- Due to the complex nature of transactions in financial markets, monitoring systems that comprise both automated and manual elements are more effective. Pre-defined transaction monitoring rules and thresholds combined with dynamic rules dependent on the customers' background and trading patterns result in more effective trade monitoring systems, in particular when the thresholds of the detection scenarios are calibrated around the specific firm's business model and risk appetite;
- There is increasing focus on network analysis and contextual monitoring based on a wider set of information about the customer and/or trade, in order to identify complicated networks or links between suspected parties or the ultimate beneficial owners behind a transaction, and, at the same time, reduce the number of false positive alerts. In particular there is greater use of:
  - Voice and e-communications surveillance - This is considered an effective resource to provide additional context to AML alerts and identify ML risks as well as market abuse exposures. Furthermore, an ongoing revision of the keywords in terms of terminology or lexicons is performed to incorporate lessons learned and emerging misconduct behaviours from ML case studies in the media;
  - Automated monitoring leveraging on the use of artificial intelligence and behavioural analysis.

The complex nature of transactions and the large number of players and jurisdictions involved highlight the value of public-private partnerships and the need for more effective communication in response to concerns or suspicions and greater collaboration between participants in the same transaction chain.

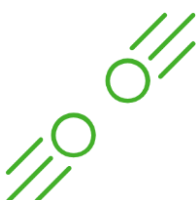
# 3. Examples of money laundering schemes facilitated by trading in financial instruments



## 3.1. Red flags for ML risks in trade surveillance

The FATF (and the FCA in its thematic review) provides a list of trade behaviours that may indicate increased risk of money laundering. The aim is to foster awareness of the potential exposures and vulnerabilities of the industry to ML risks, which are specific to trading in financial instruments. Some examples of such behaviours are set out below:

- Remote booking of trades between group entities, pre-arranged trading, instructions from or involvement of third parties;
- “Free of payment” asset transfers;
- Non-standard settlement arrangements;
- Uneconomic or irrational trading strategies of a customer without apparent market purpose or function; and
- Other unusual trading patterns, such as counterparty concentration, unusual win/loss rates or flat/neutralising activity, and a lack of trading activity on an account.



## 3.2. Impact of missed red flag trade behaviour

The importance of effective customer risk assessment and due diligence in connection with transactions in capital markets is evidenced by recent enforcement actions and regulatory investigations of market abuse where trading in financial instruments was used to facilitate or enable money laundering schemes.

A recent example concerns a leading investment bank, which raised USD6.5 billion for a sovereign wealth fund in a series of bond issues between 2012 and 2013. Prosecutors alleged that a substantial portion of the funds raised were embezzled or laundered, going through fraudulent shell companies to corrupt officials or diverted into the personal accounts of employees or related individuals, and disguised to look like legitimate business.

The fees of approximately USD600 million received by the bank to facilitate the bond deals are reported to be significantly higher than the market average fees for similar transactions. A former bank employee indicted for his involvement pleaded guilty to charges of bribery, money laundering and violation of the Foreign Corrupt Practice Act (FCPA). He admitted that the bank’s internal controls were circumvented and bribes paid to officials in order to secure the lucrative bond transactions.

### 3. Examples of money laundering schemes facilitated by trading in financial instruments

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According to public sources, two different jurisdictions initiated investigations into the matter. In July 2020, a USD3.9 billion settlement was reached with one jurisdiction to end the legal proceedings against three of the bank's units and against 17 former and current executives accused of misleading bond investors.

A second reported case concerns the Petrobras probe. In 2019, prosecutors alleged that between 2011 and 2014 four of the world's largest commodities trading firms funnelled an estimated USD31 million in bribes to corrupt Petrobras employees. The scheme was executed through oil and oil derivatives trades. The Petrobras trading division allegedly engaged with a little-known fuel brokerage firm which routinely sold fuel and oil derivatives to Petrobras at inflated prices or bought from Petrobras at discounted prices, delivering illicit profits to the other side of the trade, typically a large commodities trading firm. In exchange these firms paid kickbacks relating to the fuel trades to Petrobras officials through an offshore account under the name of a middleman.

### 4. Lessons learned and future developments

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We believe that the industry at large is still relatively unaware of its vulnerabilities to ML risks in the financial markets and is operating partially with misaligned AML and trading surveillance functions. However there are clear signals from the regulatory community and from larger market players that a change in the general approach lies ahead.

Greater efforts within the industry to further integrate the two functions can be expected in the light of intensified scrutiny by financial supervisors<sup>3</sup>, the potential for efficiency gains (in particular a reduction in the volume of false positive alerts) and a more effective management of the overall exposure to economic crimes.

The integration of AML datasets and related risk indicators, detection scenarios and thresholds within a trade surveillance system, would provide a foundation for producing fewer but more accurate trade alerts and enable more effective identification, assessment and mitigation of misconduct exposure.

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<sup>3</sup> In a July 2018 speech, the FCA Director of Enforcement and Market Oversight Mark Steward confirmed that financial supervisors and law enforcement officials had launched multiple investigations in the capital markets, both in the UK and abroad.



## 5. How Deloitte can help

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Our team of subject matter experts can support your organisation with effectiveness reviews of the implemented market conduct risk framework in order to identify vulnerabilities and optimisation opportunities in the areas of governance, misconduct prevention and detection and related controls and procedures. We are assisting with investigations and lookbacks exercises to assess and mitigate potential exposures to market misconducts and provide cost effective solutions to perform large-scale reviews. Our solutions leverage advanced data analytics techniques to monitor, profile and review data to detect key trends and anomalies in a cost and time effective manner.

## 6. What is next

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In future articles in this series, we shall provide insights into trade / trader behavioural analysis, and the trends in leveraging data and machine learning for holistic surveillance. We will also explore trends and synergies in investor protection regulations and communication surveillance.

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