FINANCIAL INSTITUTIONS AND CROWDFUNDING

Exposure to money laundering and terrorist financing and what could be done to mitigate it

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Executive Summary

Since the economic crisis of 2008, a new form of financing known as crowdfunding has taken the world by storm. Crowdfunding is the practice of funding a project or venture by raising monetary contributions from a large number of people, today often performed via internet-mediated registries. It is a form of finance, which has emerged outside the traditional financial systems.

Today, crowdfunding is the fastest growing alternative for providing capital. During 2015, worldwide financing by crowdfunding rose to an estimated $34.4 billion, which is more than double the amount raised in 2014. Its increasing popularity offers new challenges to the financial institutions.

To them, crowdfunding is a competitive source of funding that offers an alternative to the traditional form of financing. More significant is that financial institutions are passively involved. The money raised through crowdfunding will normally be passing through or stored in the accounts that they hold for their customers. When malpractices occur they will be held responsible.

Financial institutions have to comply with strict regulations. Their main area of focus is on detecting potential fraud, money laundering and even terrorist financing. Crowdfunding brings new risks. These risks are compounded by the anonymity created by the online aspect of the crowdfunding platforms and the relative ease to facilitate cross border participation.

In addition, crowdfunding often deals with small amounts over a longer period of time and runs the risk of not being picked up by the transaction monitoring tools that most financial institutions have in place. Where certain forms of crowdfunding are deemed to be low risk, financial institutions need to be more vigilant in preventing any wrongdoing. It is precisely on those areas that money launderers, individuals or organizations that are looking for channels to fund terrorist activities will concentrate. Social media poses an extra risk because anybody who uses it for crowdfunding operates under the regulatory radar.

To minimize the risk in crowdfunding involvement, financial institutions need to take additional measures. They need to know more about the customer who participates in crowdfunding and raise the awareness of those employees that are dealing with it. They also need to develop more clever and sustainable ways of improving their transaction monitoring tools to pick up irregularities.
Introduction

In the past few years, crowdfunding has become an increasingly viable alternative for obtaining capital and as such—albeit still occupying a small part of the total lending business—is a direct competitor to the traditional capital provider (i.e., the financial institutions).

Whether these financial institutions like it or not, they are not only involved because crowdfunding is a competitive source. Also because the majority of the capital thus obtained, in one way or the other, is stored or passed through the accounts of their customers.

There are currently no global laws or directives that specifically address these risks or how they should be dealt with. National laws, directives or guidelines differ from country to country and there is no harmonization effort in place to correct this. In addition, where jurisdictions do have laws and guidelines for crowdfunding, these are mostly focused on preventing fraud and malpractice in order to protect the investors. The risks of money laundering and terrorist financing in crowdfunding are underexposed.

Therefore, this paper will focus on the money laundering and terrorist financing risks, which this new form of financing poses to the financial institutions. It will also include measures that can be taken to mitigate these.

Crowdfunding

Crowdfunding is the practice of funding a project or venture by raising monetary contributions from a large number of people. It is often performed via internet-mediated registries. The concept can also be executed through mail-order subscriptions, benefit events, etc.

Crowdfunding has played a part throughout history. In 1713, Alexander Pope set out to translate Homer’s *Iliad* from Greek to English. To accomplish this task, he needed funding, which he obtained by asking subscribers to donate two gold guineas. In exchange for their donation, Alexander Pope included their names in the acknowledgment of the translation of his book.

In 1783, Mozart finished composing his piano concertos and wanted to perform these concertos at the Viennese Concert Hall. He asked people to pledge money to fund his concertos. A year later, Mozart obtained pledges from 176 people, which was sufficient money to perform at the Viennese Concert Hall, and Mozart credited the people in his concertos’ manuscript.

More recently, in the 1990s, the British band Marillion started a fundraising campaign to fund their U.S. tour. The money raised enabled them to conduct a 21 day tour.
Today, crowdfunding is practiced in various ways, depending on what the ultimate objective of the funding is about. New forms continue to be introduced. Popular forms of crowdfunding are equity crowdfunding and debt crowdfunding. The first is used to raise money in exchange for shares; the second offers participants a return interest on their funding amount. Donation crowdfunding is another popular instrument for financing.\(^1\) Other forms include reward based\(^2\) and social crowdfunding.\(^3\)

**Growth**

The popularity of today's crowdfunding can be contributed to two factors. Firstly the economic turmoil caused by the 2008 economic crisis, which tightened credit supply and secondly the ease in which people connect worldwide thanks to the development of the internet.

Between early 2009 and 2012 crowdfunding grew on average by 132 percent per annum. According to analysis done by Massolution, the year 2014 saw an explosive growth in global crowdfunding of 166 percent, raising $16.2 billion worldwide as opposed to the 2013 volume of $6.1 billion. The research performed by Massolution indicated that the accelerated rise in crowdfunding could be contributed to the fact that Asia saw an increase of crowdfunding activities by 320 percent, making up $3.4 billion of the total global volume, putting itself ahead of Europe ($3.26 billion); up until then the second biggest market leader.

In 2014 the U.S. was still the world leader in crowdfunding raising a total volume of $9.46 billion—an increase of 145 percent compared to the previous year.

**Growth in worldwide funding volume in billion dollars:**

![Crowdfunding Growth Chart]

The prognosis by Massolution for 2015 was that volumes would rise yet again to an estimated $34.4 billion. This amount constitutes less than to 0.02 percent of the originated credits provided to the real economy by the financial institutions.\(^4\)

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\(^1\) This type of crowdfunding is used by major charities and by individuals to ask a large number of contributors to donate a small amount to their cause.

\(^2\) Also known as Pledge crowdfunding. This is where individuals and companies are seeking contributions in order to develop and launch a new product.

\(^3\) An investor will lend or invest money in a business venture or project that not only will give them a good return on investment but also does social good.

\(^4\) The percentage is calculated based on figures provided by the OICD-IOSCO paper "Crowd-funding: An Infant Industry Growing Fast". It quotes peer to peer crowdfunding, which is the overwhelming contributor to crowdfunding, as representing 0.01 percent of the bank originated credits provided to the real economy.
Although this is still very small compared to the amounts of money funded through other channels, it demonstrates that crowdfunding is a phenomenon that can no longer be ignored. The exponential growth in crowdfunding can also be seen in the vast increase in platforms.

Platforms and Key Players

In 2012, there were more than 700 crowdfunding platforms worldwide. If the growth of crowdfunding platforms lives up to its expectation, there will be more than 2,000 worldwide by the end of 2016.

Crowdfunding platforms are defined as being predominately internet websites (platforms) that provide entrepreneurs and organizations (the fundraiser) a way to pitch their ideas, projects or business ventures to the public (the investors) in order to obtain funding.

Popular crowdfunding platforms are Kickstarter, Crowdcube and IndieGoGo. Less well known is that social media sites like Facebook, Twitter, LinkedIn and blogs are also utilized for crowdfunding, whereby the funds raised will be wired directly to an account held in the name of the fundraiser.

Platforms have four different types of players:

1. The people or institutions that ask for the funding (the fundraiser)
2. The people that provide the funding (the investors)
3. The institute providing the website(s) or other media that is used to obtain the funding (the crowdfunding platform)
4. The party where the funds flow through, or stores the funds (financial institutions)

The Role of Financial Institutions

The role of financial institutions in crowdfunding can be two-fold. They can be actively involved by providing their own platforms for crowdfunding, but they can also be more passively involved by providing the accounts through which the money of third party crowdfunding platforms as well as the investors and fundraisers flows or is stored.

More and more financial institutions are contemplating to, or have already set up a crowdfunding platform themselves. Not only can a financial institution charge a fee for providing the platform that brings the potential borrowers and lenders together, they already have the in-house knowledge to do a full risk assessment on the business venture as well as market knowledge on credit sourcing. For both disciplines a handsome fee can be charged.

Another phenomenon is that financial institutions are willing to finance an X percent of the total amount, whilst the rest is funded in the crowd. This will spread the
potential risks and protect the financial institution from potentially losing out to crowdfunding.

Exposure to Money Laundering and Terrorist Financing Risks

Crowdfunding adds new risks to the financial institution’s battle against money laundering\(^5\) and terrorist financing.\(^6\) These risks are compounded by the anonymity created by the online aspect of the crowdfunding platforms and the relative ease to facilitate cross-border participation. Although currently there are still little cross-border activities, some platforms have already opened their business to other countries so it can be expected that cross-border crowdfunding will grow.

What makes things harder for the financial institutions is that there are currently no global laws or directives that specifically address these risks or how they should be dealt with. The guidelines and/or directives that are available from the European Securities and Markets Authority (ESMA), the Securities and Exchange Commission (SEC) in the U.S., or the International Organization of Securities Commissions (IOSCO) focus mainly on protecting investors from becoming victims of fraud schemes. They do not specifically address the money laundering or terrorist financing aspects.

Moreover, the stringency of guidelines and directives vary from country to country. Some countries like the Netherlands and Germany have very stringent rules; others like Tunisia have none as far as crowdfunding is concerned. In countries with federal laws or directives, like the U.S., those laws or directives can be at odds with those of individual states.\(^7\)

Since there is a total absence of harmonization across jurisdictions, it is difficult for financial institutions to determine how they should shape their policies and procedures to effectively combat money laundering and terrorist financing.

One thing the various financial regulatory authorities unanimously agree on is that crowdfunding platforms that only deal with donations and reward-based crowdfunding carry a low risk, as the amounts donated are relatively small. This is not necessarily correct, since donations and sponsoring can also be a guise for money laundering or terrorist activities.

The same authorities perceive equity and loan-based crowdfunding to be a high-risk business. Their reasoning is that the amounts that are being lent or invested are

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\(^5\) An example of a Money Laundering risk using a crowdfunding platform: where a criminal pitches a bogus business venture or project to the financial institution. Once accepted all they then have to do is to ensure that their accomplices invest in this so-called business venture. By paying out an “annual dividend” the funds would be nicely laundered and ready for use. Large sums of money could be laundered through the financial system of a Financial Institution without raising any suspicion.

\(^6\) An example of a Terrorist Financing risk using a crowdfunding platform: Although the world has identified the key people in the ISI and similar networks, it is the lower ranked, relatively unknown member that poses the biggest threat. A terrorist sympathizer or even an active terrorist could seek to help his fellow men, by setting up a business venture, project or charity using the crowdfunding facilities provided by a Financial Institution. By getting people to donate money in what they believe to be a legitimate business venture, project or charity the money can then be used to carry out attacks or to buy new weaponry and supplies.

\(^7\) The state of Texas for instance strictly prohibits crowdfunding, whereas the SEC provides directives that allow it.
Financial Institutions and Crowdfunding

Substantially higher than that which is mostly given as a donation. Even more important when dealing with equity crowdfunding, investors (in exchange for giving money) receive debt securities or shares. The risk perceived is that these debt securities or shares will not be registered on a regulated stock exchange and can be sold via the internet or via another media. Such a sale can be anonymous and across borders. This makes it a very enticing vehicle for money laundering and terrorist financing.

The degree of risk depends on how a financial institution is involved with crowdfunding. In terms of risk avoidance the least risky option is when the financial institution provides and controls the crowdfunding platforms themselves. They are in a position to build-in all the safeguards to protect the platform against money laundering and terrorist financing.

Nevertheless, financial institutions operating a platform will play the role of a mediator, bringing together investors and fundraisers. By doing so, they open their doors to additional risks. One of the biggest risks is that crowdfunding often deals with small amounts over a longer period of time and as a result are not being picked up by the transaction monitoring tools that most financial institutions have in place.

The risks, however, are greater when other parties control the crowdfunding platforms which, at present, is the case for the majority of platforms.

Identifying a crowdfunding platform in itself can be tricky, especially as there is no global uniformity in the approach on how to regulate crowdfunding platforms. Although sometimes the company name might point someone in the right direction, it is not a given that it is possible to identify a crowdfunding platform by name alone.

To make matters more complicated, platforms are set up and registered at the chamber of commerce or equivalent bodies, using an array of business sector descriptions. For example, one will register a business as a financial mediation business, another will use the terminology financial advisory business, whilst yet someone else will set up their crowdfunding platform describing the company as a business that provides specialist services.

Once a crowdfunding platform has been identified, the financial institution needs to determine how bona fide it is. When determining the efforts made by crowdfunding platforms to combat money laundering and terrorist financing, the geographical location of the platform is also a key indicator.

As has been explained in this paper, this is of great importance, since not all countries have stringent anti money laundering (AML) and counter-terrorist financing (CTF) laws and regulations in place. Another important thing to remember is that not all countries require a crowdfunding platform to be formally regulated. This reflects greatly on the manner in which crowdfunding platforms conduct their AML investigations on potential investors and fundraisers.
There are a few crowdfunding sites that specifically mention having an AML or know your customer (KYC) clause in their terms and conditions.8 Other crowdfunding sites only state that personal data can be used at their own discretion.

One specific clause in the term and conditions of crowdfunding platforms relates to charity crowdfunding. Most crowdfunding platforms dealing solely in business ventures and projects have a clause that they will not support any kind of charity or donation funding.

Furthermore, most sites have a clause that lists prohibited items that they will not support. Think along the lines of projects promoting pornographic materials, drugs related crowdfunding ventures or anything to do with weapons, etc.

Last but not least, another well represented clause is the right the platform reserves to collect any personal data. These can be used to determine whether a person, organization or project is eligible to use a platform promoting their fundraising needs.

The greatest risks potentially lie with donation crowdfunding and crowdfunding through social media.

Although financial regulatory authorities believe that equity crowdfunding holds the most risk, criminals have found a way to use donation-based crowdfunding platforms as a way to launder their money. Even program makers have picked up on this fact, as can be seen in episode 12 season 2 of the American crime drama series Breaking Bad where one of the characters named Walter White Sr. launders $1.2 million of drugs money through a website to fund his cancer treatment.9

The use of social media also poses a major risk in respect to money laundering and terrorist financing, as they operate under the regulatory radar. In February 2015, the Financial Action Task Force (FATF) issued a report, highlighting social media as a way for terrorist and terrorist sympathizers to obtain funds.

In dealing with social media, the biggest problem faced by financial institutions is that there seems to be no requirements to do any KYC or due diligence10 on the users of this media. If the monitoring tools of a financial institution do not detect funds flowing into the financial system due to a crowdfunding initiative, then that financial institution is left vulnerable to an array of money laundering and terrorist financing offenses.

Although social media sites do not reference doing any due diligence on their users, they do state that if a person is involved in any suspicious activity or violates the policies or terms and conditions, they will investigate and, if necessary, terminate any

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8 Statement made based on the terms and conditions of 6 crowdfunding sites based in the US, UK and the Netherlands.
9 Breaking bad is an American Crime drama series that tells the story of Walter White a struggling high school chemistry teacher diagnosed with inoperable lung cancer. Together with his former student Jesse Pinkman Walter turns to a life of crime, producing and selling crystallized methamphetamine to secure his family’s financial future before he dies. The big problem is that Walter Sr. can’t spend the money thus gained. His son Walter White Jr. provides him with a solution by setting up an online donation page to raise money for his dad’s cancer treatment. Unable to come to terms with accepting money from strangers Walter Sr. meets with lawyer Saul Goodman and explains his dilemma over having money he can’t use. Saul suggests connecting him with a guy overseas who can set up fake accounts to funnel the money through Walter Jr.’s website in order to launder it.
10 Conclusion was based on the Terms and conditions of 3 major social media sites.
account and report the offense to the local authorities. In addition, most social media sites state that, if required, they will comply with any legal requests in any jurisdiction. The problem here is that there is no due diligence beforehand. A corrective action is only taken in retrospect, when a suspicious activity or a violation has taken place.

Mitigating Money Laundering and Terrorist Financing Risks

Participation in crowdfunding is worldwide and any measures to mitigate risks must take into account laws and regulations of all the countries that are involved in a specific crowdfunding activity.

When dealing with a crowdfunding platform it is important for a financial institution to know what type of business the platform is used to help investors and fundraisers. Equally important is it to know where the platform operates from and understand the local regulations and requirements that crowdfunding platforms need to adhere to (if any). It is also important to know its objectives and where the money comes from or goes to.

Finally, asking in-depth questions about a platform’s terms and conditions regarding their approach on mitigating money laundering and terrorist financing risks will help to understand any gaps there might be, when allowing a crowdfunding platform to use their financial system to conduct their business.

When mitigating the risks inherent to crowdfunding, financial institutions have two major instruments at their disposal. The first is procedural and is all about KYC; the second is the transaction monitoring tool that most, if not all, financial institutions have in place. Both, however, have their limitations.

They need to be workable, cost effective and ensure that they remain competitive with other financial institutions. The customer must also see it as being fair and necessary, not only for the institution itself, but also for the customer and public at large.

Any policies and procedures must also take into account the laws and regulations protecting the privacy. This is not easy, since these can form a barrier in obtaining all the information required to protect the financial institution from money laundering and other criminal activities.

Recommendations

Based on the analysis performed above, the following are recommendations for financial institutions to consider when participating in crowdfunding. The recommendations have been grouped into four categories: general, KYC, transaction monitoring and employee awareness and involvement.

General

Policies, standard operating procedures, workflows, customer relations management
(CRM) programs, etc., need to reflect the way the financial institution deals with crowdfunding.

When dealing with a crowdfunding platform as a customer, financial institutions should not get involved with any crowdfunding platform based in a jurisdiction that does not seem to have any stringent AML/CTF laws or regulations in place. Do not do any business with crowdfunding platforms that do not require any type of registration or license, unless they have proof from the local financial regulatory body that they are exempt.

Upon acceptance of a crowdfunding platform as a customer, the crowdfunding platform should have an escrow account or e-wallet held at the same financial institution as where the account of the crowdfunding platform resides. This will ensure a transparent view of how the money flows.

Currently, social media sites are not recognized by the financial regulatory authority as a potential crowdfunding platform but are leveraged as such. Therefore, they should be obliged to identify any crowdfunding activity initiated through their sites and perform a KYC and due diligence. The KYC and due diligence procedures should be publicly available.

Know Your Customer (KYC)

A financial institution operating its own crowdfunding platform runs a lower risk that money laundering or terrorist financing can occur, because they solely control those platforms. Nevertheless it will still need to have a stringent KYC procedure in place for both the investors as well as fundraisers. Taking into account that there can be a multitude of cross-border investors, mainly operating through the internet, this is not an easy task. Furthermore, they will need to investigate the business venture, project or charity of the fundraiser.

For financial Institutions providing a crowdfunding platform the following questions will need to be addressed before accepting a new investor:

- Who is the investor willing to invest money in this business venture?
- Where does the investor live?
- Where did the investor make his or her money? Or does the investor come from “old” money?
- What other business ventures or companies is the investor involved in?
- Is the investor considered a politically exposed person (PEP)?

Questions that need to be addressed before accepting a fundraiser include:

- Who is/are the person(s) behind the business venture?
- What is the business venture, project or cause they are seeking funds for and is it a legitimate business plan?
- Who controls the money?
- How well do they know the market?
• Will the product or service potentially bring any reputational risk to the financial institution?

Questions that would need to be addressed before accepting the business venture, project or charity include:

• What kind of funding does the business venture, project or charity require?
• Does the investment amount match up with other similar projects?
• What will the funds be used for specifically?
• Are there any additional laws or regulations that the project or business venture need to adhere to?
• Is there a market for this project or business venture?

If the financial institution plays a passive role in crowdfunding, i.e., if it only holds the account through which the funding platform passes or stores the money, it should already know who its customers are and should have done a full KYC upon acceptance.

However, if a crowdfunding platform would like to open a new account at a financial institution, then again a number of questions should be asked:

• Who are the directors?
• Who are the ultimate beneficial owners?
• What type of crowdfunding platform are they?
• Does the type of platform conform to the business plan?
• As a platform what services are they offering to assist in?
• Who controls the funds?
• What does their KYC policy consist of and do they have their own AML/CTF program in place? (A copy of these should be requested.)
• Does their local financial regulatory authority require them to register? If yes, then proof that they have done so should be provided.
• Does their specific crowdfunding activities require any licenses? If yes, proof of license should be provided.
• What kind of investors and fundraisers are they looking to mediate for?
• Do they have an escrow account or a so-called ‘e-wallet’? If so, is this account held at a different financial institution?

**Transition Monitoring**

To identify suspicious activities involving crowdfunding, a fair amount of money and time will need to be invested in the AML/CTF programs. Especially the transaction monitoring tool needs to be made smarter to deal with the wide range of money volumes coming into the financial institution.

The following can be done to mitigate the risks of unwanted funds being channeled through a financial institution:
Calibrate the transaction monitoring tool to trigger on certain keywords, such as crowd, funding, donation, loan, or any of the known crowdfunding platform names such as Kickstarter, Crowdcube, etc.

Set up new scenarios with a shorter time span and a lower aggregated amount. However, even if this rule can be executed in combination with the four mentioned, the downside could be a severe increase in potential alerts.

Search for out of the ordinary incoming money streams. For instance triggered when a private account suddenly shows an incoming stream of money, which cannot be explained by the normal income stream of the account holder.

Establish peer-grouping (the so-called cataloging of customers in a database). Individuals can be defined in the following groups: students, pensioners, children, etc. Businesses can be defined as small enterprise or a conglomerate. Taking this one step further, investigate if the company is part of a franchise or just a local business. Drilling down even more and look at the type of trade the company does. For instance, is it a gas station or a baker. Organizations can be divided into profit and nonprofit. Focus on the organization’s objectives and investigate whether or not this organization is active in countries that warrant an OFAC license. Each refinement a financial institution can make will help in analyzing spending patterns.

By running scenarios developed especially for each peer group, it should be possible to create a more effective way of detecting more true hits instead of false positives. However, the transaction monitoring tool has always been a tricky instrument to calibrate. Getting the balance just right is not easy.

**Employee Awareness and Involvement**

All employees who deal with crowdfunding first hand should be made aware of the risks of crowdfunding and be trained in how to deal with those risks. To accommodate this, appropriate training material should be available. This should include case studies and scenarios to show employees how crowdfunding can be used inappropriately and what the tell tail signs are to look for.

The role of the account manager should be reconsidered. In the distant past, account managers tended to know their customers intimately. Today there is more reliance on procedures and tools and less on that what the account managers know, based on personal observations. By having fewer customers in their portfolio and encouraging a more personal approach and face-to-face meetings, account managers, once they are made aware of the risks of crowdfunding, will be in a better position to offer sound advice on the trustworthiness of their customers.
Conclusion

Crowdfunding could become the new conventional way of obtaining a loan. Even though the volumes are not massive in the grand scheme of the financial world, there is a drastic growth with each year passing. New forms of crowdfunding are still developing and more and more platforms are being initiated in more and more countries.

Much still needs to be done in adapting laws and regulations to make crowdfunding less vulnerable to money laundering and other criminal practices. With the growing ease of cross-border fundraising, efforts must be made to harmonize these laws and guidelines across jurisdictions. However, financial institutions should not wait until these laws are put in place, but should act proactively.

Financial institutions should embrace this new way of financing by getting actively involved. This way they can control what kind of crowdfunding is and is not allowed to pass through their accounts.

No matter what role the financial institution takes on, it will need to update policies, standard operating procedures, workflows, CRM programs, etc., to reflect the way they deal with crowdfunding. All the time taking into account the geographical location of the crowdfunding platform and the local laws and regulations, or the lack thereof.
Works Cited


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