The Link between Money Laundering and Conflicts of Interests in the Investment Services Industry

A SWEDISH PERSPECTIVE
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Introduction

A conflict of interest is generally defined as a set of circumstances that creates a risk that professional judgment or actions regarding a primary interest will be unduly influenced by a secondary interest.¹

In recent years, the handling of conflicts of interest has gained a lot of attention in the financial industry, especially for institutions providing any kind of investment services. A Google search for the term “conflict of interest” made in July 2006 resulted in more than 150 million hits² and a more recent search made in July 2015 for the same term showed an increase of over 270 million hits.

Since the turn of the century, financial institutions have been faced with increasing pressure from regulators and supervisory authorities regarding the handling of conflicts of interests. In the EU investment services industry, this has mainly been seen as a result of strengthened investor protection regulation such as MiFID³ and the upcoming updated rules for markets in financial instruments, MiFID II. Since the implementation of MiFID in the EU there have been numerous civil penalty cases against financial institutions for not handling conflicts of interests properly. In the investment services industry, these cases have been focused on the adverse effects on investor protection. In Sweden for example, there have been several civil penalty cases against financial institutions for not handling conflicts of interests properly; however, none of them have taken into consideration that the same or intimately related deficiencies could have severe impact on the institutions anti-money laundering (AML) controls as well.

Throughout this paper, I will examine the nature of the drivers of conflicts of interest in the investment services industry, such as certain types of remuneration, and argue that the same or similar drivers of conflicts of interest that affect investor protection, in many cases, holds relevance for the effectiveness of a financial institution’s AML efforts as well.

To ensure the reader is provided with the right prerequisites for understanding conflicts of interest, the first part of this paper is mainly dedicated to explaining conflicts of interest in general.

For the purpose of this paper, I will utilize the definition of a conflict of interest as follows:

*A conflict of interest occurs when a personal or institutional interest interferes with the ability of an individual or institution to act in the interest of another party, when the individual or institution has an ethical or legal obligation to act in that other party's interest.*⁴

Although this paper is written through a Swedish perspective, this paper is intended for an international audience. I believe this is possible since conflicts of interest is an international phenomenon and therefore holds relevance outside of the borders of Sweden as well.

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¹ P.46 Conflict of Interest in Medical Research, Education, and Practice by Bernard Lo and Marilyn J. Field
² P.2 The economics of conflicts of interest in financial institutions by Hamid Mehran and René M. Stulz, November 2006
³ Markets in Financial Instruments Directive 2004/39/EC (MiFID) is a European Union Law that provides harmonized regulation for investment services across the member states of the European Economic Area.
Conflicts of Interests in the Financial Industry

The financial industry encompasses a broad range of financial institutions including banks, insurance companies, investment funds and investment firms. These institutions primarily fill two roles which are, (1) serving as intermediaries in financial transactions and (2) as custodians of assets.\(^5\) When acting as intermediaries, for example in a securities transaction, a financial institution represents both the seller and the buyer and therefore has obligations to serve the interests of both parts: the seller who wants to receive the highest possible selling price against the buyer whose interest is to receive the lowest possible buying price. The institution may also have an interest in the transaction and the price of the securities if for example the institution’s commission is based on the volume of the transaction. Even clients other than those directly taking part in the transaction itself may have an interest in it, since the value of their securities may be indirectly affected through price changes.

Due to the nature of the financial institution’s activities, it is therefore safe to say that it would be near impossible to conduct their activities without raising any conflicts of interests at all. Instead, they are obliged to weigh the competing interests of all the stakeholders, including their own, against each other. In most jurisdictions, this must be done within a regulatory framework, which adds a level of complexity to the task. This holds true especially for those institutions with a presence in several jurisdictions where the legal framework and the definition of a conflict of interest differs.

Institutions that fail to successfully manage conflicts of interest often tend to do so due to lack of documented processes, deficiencies in their internal governance and control, as well as failure to ensure that they have dedicated enough resources to be able to exercise effective control of the institution’s compliance.\(^6\)

Those institutions that do manage to establish programs to find and mitigate individual conflicts of interest are, on the other hand, more likely to pay less to administer such programs than it would cost to repair the potential damage of not having them in place. There are also other benefits of having a solid program in place for managing conflicts of interest such as:\(^7\)

- Insulating the institution from heightened regulatory scrutiny
- Safeguarding the revenue
- Protecting the brand and reputation
- Creating or retaining public trust in the organization
- Promoting the organization to clients, employees, and prospects as a responsible corporate citizens

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\(^6\) See for eg. The Swedish Financial Supervisory Authoritys decision on Mangold Fondkommission (FI Dnr 11-5811) 2013

\(^7\) P.3 “A Matter of trust: Managing individual conflicts of interest for financial institutions,” PwC FS Viewpoint, June 2012. www.pwc.com/ssi
Types of Conflicts of Interest

In their book, *Conflict of Interest in the Professions*, Michael Davis and Andrew Stark describe three distinctions commonly made among conflicts of interest that are of relevance in the financial services industry.⁸

1) Actual and potential conflicts of interest.

“An actual conflict of interest occurs when an individual or institution acts against the interest of a party whose interest that individual or institution is pledged to serve, whereas a potential conflict of interest is a situation in which an actual conflict of interest is likely to occur.”

2) Personal and impersonal conflicts of interest.

“A conflict of interest is personal when the interest that actually or potentially interferes with the performance of an obligation to serve the interest of another is some gain to an individual or an institution.” For example when an investment advisor recommends certain investments before others, not because they are the most suitable investments for a client, but because they benefit him or her the most. “However, the interfering interest may also be another person’s interest which an individual or institution is duty bound to serve.” For example, an investment manager who manages accounts for two different clients with opposed interests, being the case when a transaction on one account may have an effect on the other, can be described as “impersonal.”

3) Individual or organizational conflicts of interest.

“Organizations as well as individuals act as agents and assume fiduciary duties, and an organization can fail to serve the interests of a principal or the beneficiary of a trust even when no individual is at fault. For example, if a trust officer in the trust department of a commercial bank learns that a corporate customer of the commercial bank is in financial difficulty, should he or she be permitted or required to use that information in managing trust accounts? On the one hand, a failure to use the information could result in avoidable losses for the beneficiaries of those accounts, but, on the other hand, use of the information would violate the confidentiality that the bank owes to the corporate customer.”

Even though these three distinctions might seem obvious, they are of relevance to further understand the characteristics of conflicts of interest that can arise in institutions that are providing investment services.

Drivers for Conflicts of Interest in the Investment Services Industry

Finansinspektionen is Sweden’s financial supervisory authority that authorizes, supervises and monitors all companies operating in Swedish financial markets, including banks, investment firms, investment funds and insurance companies. It examines the risks and control systems

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in financial institutions and supervises compliance with statutes, ordinances and other regulations.

Both compliance with regulations for handling conflicts of interests and money laundering lie within the scope of Finansinspektionsen’s supervision. Therefore, cases against institutions under its supervision make up a valuable source of information about the drivers for conflicts of interests in the investment services industry.

From the beginning of the year 2012 up to today (July 2015) there have been 30 cases in total resulting in intervention from Finansinspektionsen. In seven of these cases, Finansinspektionsen found deficiencies concerning the handling of conflicts of interests by institutions.

*Finansinspektionsen decisions on the handling of conflicts of interests in financial institutions during January 2012 to July 2015*

<table>
<thead>
<tr>
<th>FI Ref. no.</th>
<th>Decision issuing date</th>
<th>Institution</th>
<th>Primary type of conflict of interest</th>
<th>Primary type of conflict of interest</th>
<th>Adverse remark</th>
<th>Administrative fine (SEK)</th>
<th>Warning</th>
<th>Revocation of authorization</th>
<th>Institution type</th>
<th>Remuneration system at fault/primary driver for the conflict(s) of interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>13-1074</td>
<td>27 June 2014</td>
<td>Skandiabanken Aktiebolag</td>
<td>Personal</td>
<td>Individual</td>
<td>Yes</td>
<td>10000000</td>
<td>No</td>
<td>No</td>
<td>Bank</td>
<td>Yes</td>
</tr>
<tr>
<td>11-5811</td>
<td>13 November 2013</td>
<td>Mangold Fondkommission AB</td>
<td>Personal</td>
<td>Individual</td>
<td>No</td>
<td>6000000</td>
<td>Yes</td>
<td>No</td>
<td>Investmen t firm</td>
<td>Yes</td>
</tr>
<tr>
<td>12-5043</td>
<td>15 March 2013</td>
<td>Global Invest Finansför medling Sverige AB</td>
<td>Personal</td>
<td>Individual</td>
<td>No</td>
<td>1500000</td>
<td>Yes</td>
<td>No</td>
<td>Investmen t firm</td>
<td>Yes</td>
</tr>
<tr>
<td>12-2525</td>
<td>10 December 2012</td>
<td>Devise Kapital Aktiebolag</td>
<td>Personal</td>
<td>Individual</td>
<td>No</td>
<td>2250000</td>
<td>Yes</td>
<td>No</td>
<td>Investmen t firm</td>
<td>Yes</td>
</tr>
<tr>
<td>10-7704</td>
<td>15 December 2012</td>
<td>Folksam LO Fond AB</td>
<td>Impersonal</td>
<td>Organizational</td>
<td>Yes</td>
<td>6000000</td>
<td>No</td>
<td>No</td>
<td>Investmen t fund</td>
<td>No</td>
</tr>
<tr>
<td>11-9769</td>
<td>20 April 2012</td>
<td>Skandinavisk Fondkommission AB</td>
<td>Personal</td>
<td>Individual</td>
<td>No</td>
<td>0</td>
<td>No</td>
<td>Yes</td>
<td>Investmen t firm</td>
<td>No</td>
</tr>
</tbody>
</table>

By studying these cases, I found that the companies’ remuneration systems often were at fault or could be seen as a predominant driver for the conflicts of interests. The way the institutions
remunerated their employees and tied agents\(^9\) could, as a single factor, create strong incentives for them to not comply with regulation and internal policies.

I also found that in most cases the type of conflicts of interests in institutions providing investment services were personal and individual rather than impersonal and organizational, which sets them apart from other financial institutions where the conflicts of interests primarily are impersonal and organizational.\(^{10}\)

**Indicators of Money Laundering and Conflicting Interests**

A rogue employee is someone who has ceased to comply with the rules or who has behaved in a manner that is benefitting the employee on the expense of the institution. As discussed above, monetary invectives can raise conflicts of interests resulting in such behavior among employees and tied agents. Individuals that deliberately do not comply with rules and regulations might pose a serious threat to an institution’s measures to counter money laundering and terrorist financing.

According to a Financial Action Task Force (FATF) typology report on money laundering and terrorist financing in the securities sector,\(^{11}\) rogue employees pose a threat even when an AML program is in place. In the typology report FATF also mention 11 indicators, which are listed below, that may be associated with an employee’s vulnerability to assisting money launderers and terrorist financiers.

1. **The employee appears to be enjoying a lavish lifestyle inconsistent with his or her salary or position;**
2. **The employee is reluctant to take a holiday or vacation;**
3. **The employee is subject to intense job-related demands, such as sales or production goals, that may make him more willing to engage in or overlook behavior that poses ML/TF risks;**
4. **The employee puts a high level of activity into one customer account even though the customer’s account is relatively unimportant to the organization;**
5. **The employee is known to be experiencing a difficult personal situation, financial or other;**
6. **The employee has the authority to arrange and process customer affairs without supervision or involvement of colleagues;**
7. **The management/reporting structure of the financial institution allows an employee to have a large amount of autonomy without direct control over his activities;**
8. **The employee is located in a different country than his direct line of management, and supervision is only carried out remotely;**

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\(^9\) In accordance with Article 23 of the MiFID, member states may decide to allow investment firms to appoint tied agents. Tied agents are (according to the directive) natural or legal persons who, under the full and unconditional responsibility of only one investment firm on whose behalf they act, promotes investment and/or ancillary services to clients or prospective clients, receives and transmits instructions or orders from the client in respect of investment services or financial instruments, places financial instruments and/or provides advice to clients or prospective clients in respect of those financial instruments or services.


\(^{11}\) Money laundering and terrorist financing in the securities sector – October 2009
9. A management culture within the financial institution focuses on financial reward over compliance with regulatory requirements;
10. The employee’s supporting documentation for customers’ accounts or orders is incomplete or missing; and
11. Business is experiencing a period of high staff turnover or is going through significant structural changes.

Not all of these indicators would be suitable for identifying employees that assist in money laundering and solely get their incentives to do so by the remuneration systems of the institutions they work for. For example, these employees would, not be “enjoying a lavish lifestyle inconsistent with his or her salary or position,” as stated in indicator number one. On the contrary, his or her lifestyle might be entirely explainable by the remuneration from legitimate sources. Whether an employee is motivated to assist a money launderer through incentives that come from the institution where he or she is employed or from the incentives from the money launderer, is therefore of relevance to those involved in investigating suspected cases of money laundering.

Key Points to Finding and Analyzing the Conflicts

Searching for answers to the following questions provided by the European Securities and Markets Authority in the MiFID Supervisory Briefings could constitute a good starting point when conducting an audit on how an institution manages conflicts of interests in general.

- How does the firm manage the conflicts that it faces?
- What procedures, systems and controls has it put in place? Who has developed these?
- How does it manage conflicts that arise from particular transactions?
- How does the firm review the effectiveness of its conflicts management arrangements?
- Has the firm ever conducted a review of particular arrangements, and with what conclusions?
- What HR policies does the firm have to manage conflicts, e.g., separate supervision?
- Does the firm have clearly defined reporting lines and areas of responsibility?
- How does the firm ensure that staff are aware of its procedures for identifying, managing, and escalating particular conflicts? What training does it provide?
- What information does the firm collect on breaches of its conflicts policy and how does it deal with such breaches?

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12 p.2 CESR/08-733
Institutions that are unable to provide satisfying answers to these questions should be placed under a higher level of scrutiny when proceeding with the audit.

To further find and analyze conflicts and utilize the FATF indicators, relevant information should be gathered from multiple sources including reports from the compliance function, auditors and supervisory authorities. Any remarks found in such reports should be examined and followed up to establish whether the institution has taken appropriate action. Information should also be gathered from relevant business units and through a review of the institution’s policies for managing conflicts of interests and remunerating its employees.

The business units could provide useful information regarding which kinds of transactions are made, sales statistics and which type of clients invest in different types of products. This information can be used to compare which investment services are provided by employees with fixed versus variable remuneration. Findings that indicate that clients with the same or similar investment profiles tend to invest differently, whether employees with fixed or variable based remuneration provide the investment services, should be treated as strong indicators of poor management of conflicts of interests. Such cases should therefore always lead to further investigation. Other findings that should lead to further investigation are statistics showing a higher acceptance rate of clients that pose higher money laundering risks to the institution among employees with variable remuneration.

The institution’s remuneration policy should be examined to establish which employee receives variable remuneration, such as bonuses and commission. This enables the auditor to effectively target the audit towards personnel that could be directly affected by conflicts of interests that arise from the remuneration system. The policy for managing conflicts of interests should be examined to establish if and how such conflicts are identified, managed and disclosed.

Even though public disclosure of conflicts of interests is preferable through an investor protection perspective it might have unwanted effects since it provides money launderers with information regarding which investment products provide employees with the highest monetary inducements. This information could enable money launderers to target their investments towards products where the employees have stronger incentives to not comply with the institution’s AML and counterterrorist financing policies and procedures.

The audit should also include a mapping of the individuals that may be indirectly affected by the identified conflicts of interests. Both individuals that may be directly and indirectly affected by the conflicts should, whenever possible, be disqualified from influence in the process of deciding how the conflicts should be managed, so that their own interests do not influence the effectiveness of the managing process. The mapping is therefore of importance when deciding how conflicts should be managed and by whom.
The Affected Stakeholders

An employee’s interest in assisting a money launderer to be remunerated by his or her employer through, for example a bonus program, can be in conflict with several stakeholders interests such as:

- Other investors, since securities transactions made by a money launderer can have a negative impact on the value of other investor’s securities. This could, for example, be the case in money laundering schemes where “one party purchases securities at a high price and then sells them at a considerable loss to another party”\(^{13}\) hence affecting the price of the securities owned by other investors.

- The financial institution, if it relies on investments made by money launderers since it may have challenges in adequately managing its assets, liabilities and operations. For example, a large portion of an investment firm’s assets under management may disappear suddenly, without notice, in response to non-market factors such as law enforcement operations or regulatory changes, which can result in liquidity problems hence effecting the institutions ability to fulfill its obligations to other investors.\(^ {14}\)

Financial institutions that are providing investment services that fail to implement and manage an effective program for managing conflicts of interests, may expose themselves to heightened risks of money laundering, which in turn can have adverse effects on the institution’s overall risk level. They also put their client’s investments at risk of being effected by transactions made by money launderers.

\(^{13}\) P.51 FATF report on Money laundering and terrorist financing in the securities sector – October 2009

Conclusions and Recommendations

Remuneration systems that can give rise to conflicts of interests might have adverse effects on financial institutions’ measures to counter money laundering and terrorist financing. When auditing an institutions program for managing conflicts of interests, auditors should be aware that deficiencies related to remuneration systems or conflicts of interests that arise due to them could serve as red flags for weaknesses in the institution’s measures to counter money laundering and terrorist financing.

Much indicates that there is a strong link between money laundering and conflicts of interests in the investment services industry. Therefore, it is recommended that auditors review the institution’s program for managing conflicts of interests when conducting an audit of an institution’s AML program, if the institution provides investment services and has a remuneration system in place that may give rise to such conflicts of interests that have been discussed in this paper.

The link between money laundering and conflicts of interests in the investment services industry remains a relatively unexplored area of study, which may have been caused by the industry’s predominant focus on compliance with the investor protection rules and regulations. When auditing conflicts of interests I would therefore urge auditors to bear in mind that the affected areas span over more than just investor protection.