

Special Audit Risk Issues Arising in International Business

The Problem of “Enabling”

The last 15 years have seen major changes in law and law enforcement as the government has tried to stem the flow of drugs and the movement of drug proceeds. In just 15 years, we have seen Federal laws enacted involving: (1) the conduct of banks and financial institutions in handling cash and international money transfers; (2) the importation of cash or bearer negotiable paper by tourists and other travelers, (3) the reporting by lawyers receiving legal fees for drug defense work; (4) the reporting by lawyers, accountants and financial advisors advising on the establishment of invisible trusts and tax haven entities; and, (5) the regulation of cambia houses, pawn brokers, travel agents and the like as “financial institutions.”

As these laws take hold and begin to have their impact, the coming phase is the government’s drive to penetrate new levels of business where seemingly innocuous transactions occur that “enable” drug trafficking by providing a source of currency able to cross international borders undetected and unmolested. This new business environment presents **Special Audit Risks**; for life-ending consequences can flow from conducting international business with inadequate diligence on legal compliance. Audit programs that do not identify these material business risks fail to provide adequate information to international businesses and their supporters.

Discussed below are two of the techniques drug dealers and money launders use to ply their trades and the actions taken by law enforcement to stop them. Unfortunately, legitimate businesses are viewed as “enablers” of drug trafficking and money laundering and are the likely injured bystanders in this war. The question is whether they are innocent bystanders.

I. The Black Market Peso Exchange

The two principal uses of the Black Market Peso Exchange (“BMPE”) are: (1) for the conversion of non-U.S. currency earned by lawful businesses in drug producing countries to U.S. dollars to pay for imported goods; and, (2) to conceal tax, customs duty and currency evasions committed by legal businesses that import products purchased in the United States with U.S. dollars. In both cases, the objective is to convert money to or from U.S. dollars and to move U.S. dollars or non-U.S. currency across international borders.

The risk associated with the Black Market Peso Exchange is that United States businesses engaged in ordinary international transactions are exposed to extraordinary liability by being enmeshed in such transactions. This can happen without any intent to act unlawfully. United States businesses engaged in importing and exporting, shipping, freight forwarding and customs brokering are routinely exposed to these risks. The **Special Audit Risk** is failing to identify for these businesses the liabilities, sometimes-unlimited liabilities, arising from otherwise lawful transactions. The goal is to identify the liabilities and advise these businesses how to avoid incurring them.

Internal Revenue Service Criminal Investigation function (IRS-CI) has and will continue to identify money brokers, vendors and money services businesses that are suspected of assisting drug dealers in transferring drug proceeds through the Black Market Peso Exchange. The IRS-CI has successfully prosecuted money brokers and vendors who assisted drug traffickers by selling merchandise overseas through the Black Market Peso Exchange.

In September 1999, the IRS-CI conducted a long-term undercover operation that targeted the Black Market Peso Exchange transactions between Colombia and Florida. Sixty individuals were indicted, including sixteen Colombian nationals who were currency dealers or business owners, nine couriers or representatives for the Colombians residing in the United States (the intermediate levels of artificially layered transactions) and thirty five South Florida vendors and sales representatives associated with sixteen separate otherwise legitimate business entities. This undercover operation received and laundered over ten million dollars in drug proceeds. Some of the drug proceeds was used to make a large purchases of computer related products from Florida businesses. It should be noted that not one business involved in the sting refused to do business with the undercover agents although the conditions that marked such transactions as high risk were presented to the Florida businesses.

a. How The Black Market Peso Exchange Works

A foreign business in a drug producing (or bordering) country desires to purchase United States goods for importation. The products must be paid for in U.S. dollars. Thus, a demand for U.S. dollars is created. For purposes of the Black Market Peso Exchange, United States goods may mean goods manufactured anywhere as long as the goods are sold from the United States. For example, Japanese made goods shipped to Miami for resale in Latin America may be involved.

The foreign business contacts a currency dealer in the drug producing state. This currency dealer has an inventory of U.S. dollars in the United States. The foreign business buys the U.S. dollars needed. Usually the exchange rate and transaction fee are better than offered by the national banks. The foreign business pays the currency dealer in non-U.S. currency. The currency dealer delivers the dollars to the foreign business in the United States. The U.S. dollars may be in the form of money orders, third party checks, checks drawn on personal bank accounts, travelers' checks, or drafts from foreign banks. These dollars will clear through U.S. dollar bank accounts of United States banks or foreign banks with correspondent relationships with United States banks. Wire transfers to United States bank accounts established by the foreign business or its "buying office" may be used. The least likely form of payment is cash, since even the most cavalier seller knows it must report large cash transactions.

Once the foreign business receives the U.S. dollars, they are delivered (in various forms) to the United States seller from whom goods are purchased. The seller receives the payment in U.S. dollars and the goods are shipped, or if previously shipped, the payment is applied to the trade receivable of the seller.

As a result, the currency dealer has an increase in its non-U.S. currency in the foreign country. The currency dealer sells its non-U.S. currency to the drug producer in the drug producing country who operates in non-U.S. currency. The currency dealer is paid in the United States with the profits from the drug sales sold in the United States.

The cycle is complete and may begin again. No cash actually derived from a drug sale crosses an international border. No drug proceeds are even electronically moved by the drug dealer, from its operations in the United States, to the drug producing country or cash haven. Nevertheless, drug dollars in the United States have been converted to non-U.S. currency in the drug producing country. Drug proceeds have been laundered through activities of otherwise lawful businesses conducting innocuous transactions.¹

The participation by United States businesses in lawfully selling, forwarding, shipping, declaring, receipting, and clearing the goods or payments can create liability for the United States business.

b. Law Enforcement is Catching Up

The Department of Justice and the Treasury Department are required to present anti-money laundering enforcement strategies to Congress each year. The “strategy” for the year 2000 specifically named the “Black Market Peso Exchange” as a system to be aggressively attacked by law enforcement. Law enforcement, following drug proceeds, will trace the cash to individuals working for the currency dealer. This may be the only point of contact between the drug trafficker and legitimate business. The investigation will then identify the U.S. dollar accounts used by the currency dealer. Analysis of these accounts will identify drug money going through these accounts to the accounts of legitimate businesses. Funds transferred out of target accounts are traced until the bank accounts of legitimate businesses are reached. These accounts are examined to determine how the legitimate business is enabling the drug traffickers. If it is

¹ Summary of Facts about the “Black Market Peso Exchange” or “BMPE”

- It has been an active part of financial activity for more than 50 years;
- It was not created for benefit of drug traffickers, it was created by otherwise legitimate businesses with U.S. dollar needs inside the United States with transactions in non-U.S. currency outside of the United States;
- Originally, it was driven only by the demand for the U.S. dollars, now it is driven by the demand for U.S. dollars by legitimate overseas businesses and by the supply of dollars earned in the United States by drug dealers;
- Not illegal, by itself, under the U.S. Money Laundering laws, but can be coupled with other acts to comprise an unlawful act; and,
- Dollars available on the black market come from a variety of sources; including, drug trafficking, tax - customs duty - currency evasions, legal businesses such as coffee, flowers, manufactured goods (replacement car parts).

and there is evidence that the legitimate business is acting unlawfully, law enforcement has the right to seize the “proceeds of drug trafficking” traced to those accounts.

A legitimate business² enables drug traffickers, possibly unlawfully, by: (1) accepting and not properly reporting cash or cash equivalent payments; (2) receiving third party payments; (3) receiving structured payments to avoid cash or cash equivalent reporting; (4) allowing multiple layers of transactions through third parties (often the legitimate business is told the third parties are brokers, aggregators, consolidators, or buying offices); (5) failing to “properly” know its customers; (6) selling extraordinary quantities of fungible, easily sold goods (CPUs, computer parts, tires, electronics, cameras, cellular telephones) to layered non-domestic companies with no apparent business operations (often such sales are conducted COD since there are inadequate credit histories, D&B and NACM reporting of the buyers).

Law enforcement clearly understands that currency dealers enable the drug dealers to enjoy the trappings of their success, pay for goods and services, support and expand their criminal enterprises and operate. It is also believed by law enforcement that the removal or dismantling of the currency dealers providing service to drug traffickers will adversely affect drug trafficking. Causing legitimate business to curtail use of currency dealers is a practical step for law enforcement. This will occur through increased surveillance of currency dealers and legitimate businesses that are paid through them, together with penetrating examinations and audits of the transactions to expose the “enablers.”³

² High risk legitimate businesses already getting enhanced scrutiny as “enablers” are:

- Currency exchange houses, money remitters, checks cashers; casinos;
- Offshore corporations and banks located in tax/banking havens;
- Leather good stores;
- Car, boat, and plane dealerships;
- Distributors of high priced and easily marketed goods such as computers, computer parts, electronics, and cellular telephones;
- Used car and truck dealers and machine parts manufacturers;
- Travel agencies;
- Brokers/dealers in securities;
- Jewel, gem, and precious metal dealers;
- Import/Export companies
- Cash intensive businesses (restaurants, retail stores)
- Telemarketers.

³ High risk actions of legitimate businesses likely to engender high scrutiny are:

II. Overpricing and Underpricing Schemes for Import and Export Transactions

One new and very special “look” at the “enablers” is the action of the Office of the Comptroller of the Currency (OCC), whose manual was updated to enhance the examiner’s responsibilities in the area of Bank Secrecy Act compliance, Suspicious Activity Reporting and reviewing anti-money laundering policies and procedures. The OCC examines banks and financial institutions. Now it will examine those businesses to determine what their customers are doing. This will include customers that are engaged in legal activities that “enable” drug traffickers and money launderers to ply their trades. Some of the “high-risk industries” are listed in footnote 2. The OCC has instructed examiners to look at bank-to-bank payment arrangements such as letter of credit transactions and shipping documents against payment transfers (these are known as D/P payments) for overpricing and underpricing of imports and exports.

Money laundering through false invoicing in international trade is a growing problem according to a study by Florida International University. Accordingly to the analysis conducted by business professors Simon Pak and John Zdanowicz, more than \$131 billion was laundered out of the U.S. in 2000 due to artificial overpricing and underpricing of products entering and leaving the U.S. Using the same methodology, the two researchers estimate that money laundered through phony pricing schemes totaled \$105 billion in 1998 and \$126 billion in 1999. This problem is not unique to the United States. Examining trade between the U.S. and Switzerland before and after implementation of the new Swiss money laundering law in early 1998, described as the world’s toughest, the amount of money that moved between the countries at grossly abnormal trade prices an increased from \$370 million per month to \$776 million per month.

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- Use of private banking facilities;
 - Engaging in offshore international activity, especially in tax haven jurisdictions;
 - Using deposit only facilities, including lock box accounts with offshore depositing of payments for United States goods;
 - Use of unusual wire transfer and cash management functions, particularly in banks not holding accounts of customers;
 - Wire transfers and banking transactions in which the primary beneficiary is undisclosed;
 - Using loan guarantee schemes, where the guarantor ponies up the payment;
 - Using travelers checks instead of business checks;
 - Using officials bank checks instead of business checks;
 - Using money orders instead of business checks;
 - Trade Financing transactions with unusual pricing features; and,
 - Using payable through accounts (PTAs).

Money laundering through false invoicing is an outgrowth of law enforcement's effort to identify and forfeit money laundered through the banking system. Except for the detection of evasion or avoidance of customs duties, overpricing and underpricing has been all but ignored in law enforcement's efforts to prevent money laundering of drug proceeds. Law enforcement, other than the U.S. Customs Service and the IRS, have not had responsibility for analyzing international transactions involving otherwise routine imports and exports. For the U.S. Customs Service and the IRS, their responsibility has been policing the pricing of imported and exported products for duty collection and transfer pricing enforcement. Neither effort was targeted at nor useful in identifying false invoicing as a means to laundering money earned from illegal drug transactions.

The **Special Audit Risk** pertaining to these matters is easily overlooked, as transfer-pricing issues are routine financial audit and tax return issues. However, the issue here does not pertain to the overpricing or underpricing of goods by United States businesses for these businesses are not "conspiring" with the drug traffickers and money launderers. Rather, the pricing issues occur in layers of transactions not necessarily apparent to the United States business but facilitated and enabled by a lack of diligence of the United States business. The liability of the United States business arises when law enforcement says that it is intentionally blind to the consequences of its actions. This can be said as much to the freight forwarder, shipper, and customs broker as it can for the seller for each of these businesses play a role in international trade that the lawbreakers need to conduct their transactions.

a. How Overpricing and Underpricing Works

Overpricing and underpricing occur as follows. An overseas business desires to purchase U.S. goods for importation. The U.S. merchants they purchase from need to be paid in U.S. dollars, not foreign currency. The goods will be sold in the foreign country for non-U.S. currency. Thus, a demand for U.S. dollars and a supply of non-U.S. currency is created.

Drug dealers own millions of U.S. dollars from drug trafficking in the U.S. The drug dealers need non-U.S. currency to function in the drug producing countries. The drug dealers are willing to sell U.S. dollars for non-U.S. currency, particularly since the drug dealer has trouble laundering its drug trafficking proceeds through U.S. banking channels. The drug dealer buys \$1 million of U.S. products paying for them with drug proceeds. The drug dealer sells the goods, directly or through intermediaries, to overseas businesses that sell U.S. purchased goods in non-U.S. currency. A portion of the selling price is paid in the U.S. in U.S. dollars; the balance is paid to the drug dealer in non-U.S. currency in the foreign country. U.S. drug proceeds have thus been converted to non-U.S. currency in the drug producing country. The proceeds of drug sales have been laundered.

To conceal these transactions from law enforcement in the U.S. and the foreign country, gross underpricing of U.S. exports occurs. Only the U.S. dollar pricing portion is reflected in the invoicing and customs declarations. This is more than the routine case of undervalued importations since the transaction documents in both countries reflect the underpricing. To accomplish this, the goods are sometimes sold through reams of paper transactions without any

actual movement, each transaction adjusting the gross price of the goods or the value per unit. Inevitably, the goods and the paper come to rest in the hands of a freight forwarder who unwittingly executes the laundering. Sometimes re-papering is done at sea to further avoid detection by law enforcement. Re-papering places the shipper and freight forwarder in the middle of the laundering effort.

The transaction can also occur in the reverse. Foreign businesses selling in the U.S. present an opportunity for drug traffickers to move their money outside of the U.S. Here, however, the object is overpricing. To move drug proceeds out of the country, U.S. importers purchase a variety of products such as flowers, coffee, car parts and pottery at inflated prices. To conceal the profits from foreign governments, overseas product brokers participate in re-papering the transactions, sometimes at sea, to facilitate inflating the cost of products entering the U.S.

b. Law Enforcement's New Approach

If law enforcement is able to follow the drug money, the cash is traced to the goods purchased and the ultimate consignee. This leads to the identity of the United States businesses lawfully selling goods to businesses overseas that facilitate drug trafficking. The government has the right to seize the "proceeds of drug trafficking" traced to these accounts and seize the products purchased with the proceeds of drug transactions. The United States businesses then have to prove that it did not facilitate the laundering of drug proceeds.

The issue for the customs broker is the declared value of the import and the export with new arms of law enforcement engaged in the inquiry. Moreover, law enforcement has an enhanced credo to stop the traffickers by stopping the "enablers." A "knowledgeable" broker or one who is "intentionally blind" to the facts around him is an "enabler." He has more to worry about than he thinks, as does the freight forwarder and shipper who is deemed to have "knowingly participated" in fraudulent re-papering of imported or exported products. In both cases, they may be viewed as having facilitated the laundering of drug proceeds.

III. Due Diligence and Why It Is Important

What does law enforcement expect of United States businesses engaged in international transactions? It expects due diligence. In light of the international nature of business and the increasing number of countries that have criminalized money laundering, the best way for any businesses – United States or foreign – to protect themselves from losses or fines is to take reasonable steps to ensure that it is not doing business with criminals or facilitating and enabling the business of criminals. Financial institutions and other businesses susceptible to losses caused by enabling money-laundering schemes need safeguards in place, specifically, due diligence programs.

Due diligence programs for businesses engaged in freight forwarding, shipping, customs brokering and international sales of targeted goods must include procedures to guard against transactions with customers in layered transactions where the products and money have indirect paths and the baseless insertion of nominal entities. Moreover, it is imperative for companies

purchasing businesses or entering into strategic alliances abroad, to perform thorough due diligence reviews of their business partners. The consolidation of businesses through mergers and acquisitions requires enhanced due diligence of not only the target of the acquisition but of recent layered and indirect transactions that would not be acceptable to the United States business had the United States business conducted the transaction itself.

a. Simply what is Due Diligence

Due diligence means knowing the customer enough to develop reasonable expectations of customer activity and the ability to identify changes and aberrations in customer behavior. The United States business must ask:

- Do I know the true beneficial owner and party to this transaction?
- Is this someone I have done business with and should do business with?
- Do I know enough about this person or business to be comfortable having this business relationship?
- Do I know the source of funds for this transaction?
- Do I know the use of the products or services I am selling?
- Does the business activity and patterns of transactions make sense under the circumstances?
- Do I have the knowledge and means to detect changes in behavior?
- Do I know enough to discern unusual and suspicious activity?

Notably, what law enforcement frequently remarks about these questions is that they are the very same questions businesses usually ask before making sales on credit. In the case of the sale of restricted items such as computers, computer parts and other electronics, they are questions that must be asked before the sale can be made. Yet, few businesses establish due diligence programs to raise these questions when engaging in transactions that enable drug trafficking and money laundering.

For importers, freight forwarders, shippers and customs brokers the norms associated with law abidance with import and export transactions are viewed as part of the daily function of these businesses. The implication is that these businesses have enough awareness of governmental regulation of their activities that they should already be alert to due diligence issues. Any failure to address these issues is a sign of “intentional blindness.”

A **Special Audit Risk** arises from the extraordinary liability that may be incurred by businesses conducting a large number of routine transactions in ways law enforcement may view as facilitating drug trafficking and money laundering.

b. What Does Due Diligence Do for a Business?

Last year President Clinton signed the Civil Asset Forfeiture Reform Act of 2000 (CAFRA). CAFRA went into effect in August 2000. Among many other things, CAFRA provides for statutory innocent ownership claims to assets traceable to illegal activities if the assets are acquired in a legitimate manner and the new owners are not party to the underlying criminal offense. The owners must also have no knowledge that the assets they acquired are subject to forfeiture at the time they gain control of the assets, thus implicating the function of due diligence in international business transactions. Assets acquired include money received in payment for the service rendered by the innocent third party service provider. For example, broker fees and shipping charges are “assets” acquired and can be the subject of forfeiture if earned in transactions traceable to illegal activities. Likewise, CAFRA has a direct impact on individuals and businesses receiving funds traceable to the BMPE in arms-length transactions involving the sale of products and in transactions involving overpricing and underpricing. As to property acquired after the acts giving rise to forfeiture, claimants must prove by a preponderance of the evidence that they are bona fide purchases (or sellers or service providers) for value (with a few narrow exceptions) that did not know and were without reasonable cause to believe that the property was subject to forfeiture. 18 U.S.C. § 983(d)(3).

CAFRA also requires the U.S. government agents and prosecutors to produce evidence in forfeiture actions that exceeds previous legal requirements. CAFRA provides more opportunity for innocent owners to seized assets to prevail in civil litigation matters brought in money laundering investigations. Success will often hinge on the due diligence practices of the innocent owners and the ability of the innocent owner to prove that its compliance practices are adequate and yet failed to detect evidence of a problem. Remember, the innocent owner is not a police force for international trade. Reasonable care coupled with due diligent practices is the predicate for innocent party relief under CAFRA.

The trades and businesses, customs brokers, freight forwarders, correspondent banks, private banking accounts, payable through account relationships and funds transmitters are easily engulfed in legal actions surrounding the attack on the BMPE and overpricing underpricing schemes and can easily become casualties in the conflict between law enforcement authorities and criminal organizations.

The BMPE and the overpricing and underpricing schemes are key areas for international businesses where civil forfeiture rules have changed are as follows. Under prior law, civil forfeiture for proceeds of specified unlawful activity offenses was often limited to forfeiture of property, which was also involved in money laundering transactions. There was authority to proceed with civil forfeiture cases against a few Specified Unlawful Activities (“SUAs”) for direct proceeds forfeiture but money-laundering transactions were also required for most SUAs. As of CAFRA, proceeds of all SUA crimes are subject to direct civil and criminal forfeiture. 18 U.S.C. §981 (a)(1)(C) (civil forfeiture of SUA proceeds); 28 U.S.C. § 2461(c). Proof of a money laundering transaction per se is no longer a prerequisite to forfeiture of SUA proceeds. Thus, SUAs now include the full gamut of false statements made in the process of importing and exporting goods from the United States and false statements made in the process of paying for

and receiving payment from international transactions where false statements were made in the course of the importation and exportation of the goods. All machinations of the BMPE and overpricing and underpricing are now clearly SUAs.

CAFRA expands the liability that attaches to laundered money (and money otherwise subject to forfeiture) that makes its way into bank accounts, even the bank accounts of innocent owners, including service providers such as freight forwarders, customs brokers, lawyers, accountants and others. 18 U.S.C. § 984(d).