Drawing conclusions about financial fraud: crime, development, and international co-operative strategies in China and the West

Allan Castle, PhD
Director, Transnational Financial Crime Program – The International Centre for Criminal Law Reform & Criminal Justice Policy, Vancouver, Canada

Abstract

This paper, taking as its foundation the belief that financial fraud is a serious long-term threat to peaceful and democratic socio-economic development, develops three broad themes in reaction to the issues raised in the Symposium.[1] First, at the broadest level, for China and other countries the struggle against financial fraud is an issue of development and institution building. Second, effective measures against financial fraud involve taking strategic decisions in applying scarce resources, as national efforts and international co-operative initiatives will inevitably be subject to greater constraint on finances and personnel than is the case for those engaging in fraudulent activities. Finally, more than being simply beneficial, co-operation between jurisdictions is a necessary starting point for combating this problem, and entails the partial surrender of sovereignty in pursuit of an effective coordinated response.

Financial crime, sometimes referred to as 'white-collar' crime, does not live as vividly in the public imagination as other sorts of criminal behaviour. Crimes of violence or which contain the threat of violence, such as murder, rape, assault, or robbery, are easy targets against which to mobilize public outrage and develop legislative and enforcement responses. Fraud, whether it involves bogus investment deals, money laundering, or plastic card-related theft, engenders less outrage in comparison. The reasons for this are fairly straightforward: in economic terms, white-
collar crime typically has diffuse costs (to society) and concentrated benefits (for the perpetrators). Even when the costs are concentrated, as when one individual or company is defrauded of a large sum, public perceptions of foul play are often tempered by a belief that

[1] This paper was prepared for presentation at the International Symposium for the Prevention and Control of Financial Fraud, Beijing, October 19-22 1998. The author would like to acknowledge the support of the Solicitor General of Canada, Justice Canada, the Royal Canadian Mounted Police, the International Centre for Criminal Law Reform & Criminal Justice Policy, and the private sponsors of the Symposium.

crime which targets the wealthy is of less concern as the effects are cushioned for the victim.[2]

However, as the other papers presented at this Symposium demonstrate, if the costs of financial fraud are diffuse and subtle in the short term, in the longer term they have the potential to undermine the basic tenets towards which modern society strives, including democracy, accountability and the rule of law. Economies built on opaque practices and poorly regulated financial sectors are more vulnerable than most. Financial fraud can only flourish in environments where the origin and destinations of funds are easily concealed, where personal connections trump requirements of open reporting and auditing practices, and where regulatory structures and legislative provisions are inadequate to combat the threat posed by these activities. Financial fraud undermines democratic institutions by assailing public faith in fairness and openness of societal outcomes. Leaving aside moral or legal considerations, financial fraud has significantly negative implications due to its parasitic role in the economy. It undermines legal economic practice by introducing artificially high elements of risk in investment and business, and by providing incentives to 'get-rich-quick'. It is a truism to point out that government legitimacy and hence public security in many states is compromised by widespread suspicion of fraud and corruption at the highest levels – a phenomenon of which Russia and Mexico are but two high-profile contemporary examples.

In providing comparative analyses of China, Canada, the United States, Australia, Japan, and other countries, the papers presented at the Symposium have yielded much insight. This paper, taking as its foundation the belief (as outlined above) that financial fraud is a serious long-term threat to peaceful and democratic socio-economic development, develops three broad themes in reaction to many of the issues raised here. First, at the broadest level, for many countries (including China) *the struggle against financial fraud is an issue of development and institution building*. Second, *effective measures against financial fraud involve taking strategic decisions in applying scarce resources*, as national efforts and international co-operative initiatives will inevitably be subject to greater constraint on finances and personnel than is

[2] Financial fraud thus possesses the basic elements of a 'collective action problem', in which both individuals within states – and individual states within global society – are able to exploit the concentrated benefits of engaging in behaviour broadly but diffusely detrimental to the broader society at large (the state, in the case of the individual, or the international community, in the case of the state). We should therefore not be surprised to find similar impediments to the solution of the problem of financial fraud as are found in attempts to combat global environmental degradation or violation of intellectual property rights.

the case for those engaging in fraudulent activities. Finally, more than being simply beneficial, *co-operation between jurisdictions is a necessary starting point* for combating this problem, and entails the partial surrender of sovereignty in pursuit of an effective coordinated response.

Financial fraud and development

In reviewing the Chinese experience and comparing it to that of other jurisdictions, as we have done this week, it has become clear that China faces a unique situation in historical terms – a challenge with 'Chinese characteristics'. To begin with, the differences between China and the West include the obvious fact that the Western countries have a longer tradition of regulating and legislating against white-collar crimes. In the vast period of change undergone by China in the last century, China has only in recent years been able to implement legislation and regulatory bodies to control financial fraud. But in recognizing this simple truth, we should beware of viewing the scenario as one of China 'catching up' with foreign states, because China is facing a situation that none of the Western states has faced.

The evolution of the Western economy into a modern capitalist industrial society took place over many centuries. At each step along the way, the state was able to introduce appropriate levels of regulation as new problems emerged.[3] For China, the situation is radically different. Since the beginning of the Open Door, the economic power of China has grown rapidly. While the capitalization of the Chinese economy is not (and may never be) complete, the changes have been so sudden as to leave the supervisory structures of the command economy trailing in their wake. Suddenly, Chinese lawmakers, judges, police, and a host of new, independent economic actors are faced with all the problems of a modern capitalist economy. By contrast, there has been little time to prepare to regulate against abuse, and little experience to draw on in an era of rapid international economic and technological change. The gap between economic activity and regulatory capacity is a challenge never faced by the West, and thus blanket prescriptions from outside experience

[3] See, for instance, the work of Michael Mann, whose analysis of the expansion of European states in transition from the Dark Ages to the early modern period charts the regular 'ratchet' effect (over many centuries) of state bureaucracy and expenditures rising in lock-step with the challenges thrown up by

are likely to be, if not entirely useless, of only moderate utility in devising effective strategies to combat financial fraud.

The recent insertion of China into global financial markets, typified by the development of Shanghai as a major regional financial centre, has for the Chinese leadership meant coming face to face with sophisticated criminal behaviour. This encounter has been complicated by the fact that the last decade has seen a genuine revolution in communications and commercial technology. This situation presents major challenges for any regulatory structure, let alone that of a state in transition to a 'socialist-market' economy. The problems faced here are not simply those of regulating a Chinese market economy, but of dealing with a massive global marketplace capable of concealing (through administrative or electronic means) illegal assets, and of confusing those who search for those assets.

Almost all of the fraudulent and criminal activities discussed in this forum – tax evasion, drug trafficking, fraudulent investment schemes, misappropriation of public funds, credit card fraud, and banking fraud – possess one common element: they use the same system to launder the proceeds of crime and fraud. In the West, and increasingly in China, the origins of criminal proceeds are often concealed using financial institutions in overseas or offshore jurisdictions willing to keep the identity of the client and the source of the funds anonymous.[4] This system has emerged over the course of this century and is highly sophisticated. For a society only now coming to terms with the difficulties this system poses to the investigation of financial crimes, complex international money laundering opportunities pose a massive challenge.

The situation is complicated by the fact that the leading Western states exhibit a somewhat divided view on this matter, in practice if not in public statements. While anecdotal, the example provided by the *Economist* is illustrative. A leading publication catering to the policy, academic and financial communities of the English-speaking world, the *Economist* has devoted several cover stories in the last year to the problem of opaque

---

international political competition and the rise of autonomous sources of domestic economic and political power. Michael Mann, *States, War and Capitalism*, Blackwell Books, Cambridge MA, 1988.

[4] The literature on money laundering is vast. For an introduction see Peter German, *Proceeds of Crime*, Carswell Books, Scarborough, Ontario 1998; for analysis by country see the *1997 International Narcotics Control Strategy Report*, US Department of State (Bureau of International Narcotics and Law Enforcement Affairs) 1997, or Fletcher N. Baldwin, Jr. and Robert J. Munro, *Money Laundering, Asset Forfeiture and International Financial Crimes*,

financial markets and the problem they pose for tracing criminal funds.[5] Yet the same publication, unrivalled in prestige as an elite journal of political economy, devotes in those same issues large amounts of space to advertising by companies involved in providing second passports, offshore trust accounts, anonymous banking services, and other tools of money laundering. The reason for this is simple enough: *The Economist* has an affluent readership, and there is a long tradition of economically advantaged people in Western society moving their income to offshore locations to avoid paying income and other taxes levied by the state. A lack of coherent public debate over the ethics of avoiding taxation has made it difficult to attack the practice of money laundering as effectively as might have been done in other circumstances.

This partial failure to crack down on laundering activities elsewhere presents China with even greater challenges. The temptation to blame foreign financial markets and lax foreign regulations for the situation China faces is significant. Unfortunately, to do so will be as futile as it may be satisfying. The reality is inescapable: it is more important than ever for China to build and maintain a transparent and accountable financial sector, and to co-operate with other countries in legal matters. China's recent efforts in these areas, and its membership and participation in the Asia-Pacific Group on Money Laundering, are to be welcomed and encouraged in this light. To fail in this regard is to make the Chinese economy an attractive destination or transit point for criminal assets, with all the deleterious consequences for socio-economic development that such an outcome entails.

The importance of cost-effective strategies

Any search for an effective anti-fraud strategy will encounter the problem of scarce resources. It is often remarked-on in reviewing enforcement practices in the West that the amounts spent on investigation will regularly exceed the total proceeds of the crime involved – with the occasional exception of spectacular drug busts or the successful forfeiture of fraudulently obtained assets. One central issue that emerges is thus the difficulty of achieving concrete results in the struggle against financial fraud while operating

---

Oceana Publications, New York 1997; for suggested countermeasures see the pamphlet *The Forty Recommendations of the Financial Action Task Force on Money Laundering*, FATF Secretariat (OECD), Paris 1997.

[5] See e.g. *The Economist*, May31-June 6 1997 (cover: 'The disappearing taxpayer'); July 26-August 1 1997 (cover: 'Cleaning up dirty money').

on a limited budget. As underscored by many of the papers in this collection, there are a number of methods available to the policy-maker in defining a cost-effective response.

First, it is useful (and probably necessary) to have individuals with direct policing and/or forensic investigating experience and skills located in a compliance and investigative capacity within financial institutions. Within most major financial institutions in the West, it is the rule rather than the exception for there to be former senior police personnel in key positions overseeing the security and compliance operations of the institution.

Second, while added and enhanced legislation regarding fines, incarceration, and other penalties for offenders is an obvious and necessary part of any modern regulatory system, there is a major need in any setting for complementary civil and administrative solutions to financial fraud. Here, the use of self-regulation of financial industries and the application of non-criminal penalties has proven to be both cost-effective and time-efficient in combating fraud in the Western context. State authorities in a variety of jurisdictions have chosen (particularly but not exclusively in securities markets) to delegate power to industry regulatory bodies, and to encourage the development of internal controls within financial institutions. Not only does such an approach reduce costs, but it also possesses the additional advantage of limiting publicity surrounding frauds, thus allowing financial institutions to cooperate in the regulatory regime without fear of losing business after the exposure of a major transgression. As pointed out in the sessions on securities fraud, knowledge of the punishment decided upon by an industry regulatory body will often spread quickly through word of mouth in financial circles, without general publicity which might damage public confidence in the market as a whole. While there may be valid ethical reservations concerning the effect of financial imperatives on the administration of justice, the strength of this pragmatic approach lies in its effectiveness in achieving industry compliance at little cost to the state. It must be remembered as well that in allowing financial institutions to participate in policing these crimes, the incentive of preserving the integrity of their own economic milieu (with the obvious benefits that accrue) is activated.

Third, while enforcement agencies are often able to track the methods used by criminals in perpetrating frauds, criminals are often just as or more sophisticated. We can never know, but we must suspect, that there exists a mass of undetected fraud due to the sophistication and subtlety of the approach used. Naturally, we never hear about the cases that escape detection (dogs that do not bark). Thus the imperative to share technology,

best practices, techniques, and even personnel, between policing, prosecution and financial organisations is of increasing relevance.

Fourth in this brief list is the importance of legislation which allows for corporate criminal liability (the criminal liability of 'legal persons'). The question of the legal status in criminal matters of a corporation runs into major objections in many legal contexts. However, one of the key assets of the criminal in the perpetration of financial fraud is the ability to use corporations, whether in the form of domestic holding companies, or in the usage of anonymously-owned 'shelf' corporations (or IBCs), as a shield from prosecution. An effective legal regime in the struggle against financial fraud must possess the ability to render corporate entities (and thus the persons responsible for their existence) criminally liable. The debate over this issue continues in China, just as there are debates also in many European and Latin American civil law countries over the same issue. In this space, it is enough to highlight the worth of this measure.

The necessity of a commitment to international co-operation

The lesson from the ideas presented in this forum is clear when it comes to international co-operation: without it, there can be no effective measures taken against financial fraud, which is increasingly an international phenomenon. Moreover, with this commitment there must come a realization that joining forces with other states in addressing this common enemy entails for each state the surrender of a degree of sovereignty over its own legal destiny. We should note first, therefore, that this reciprocal surrender of sovereignty, or opening, is essential.

By way of illustration, we may see that this is particularly true in the case of international co-operation against money laundering through the leading body in the area, the Financial Action Task Force on Money Laundering FATF. The strength of the FATF's approach has come through its system of mutual evaluations, where member states voluntarily undergo assessment by fellow member states vis-à-vis their adherence to international legal norms concerning money laundering. Traditionally, in the study of international relations, scholars are sceptical about the effectiveness of voluntary international commitments. In light of this scepticism, the FATF's experience must be seen as a happy exception.

In a recent case, we may take the Canadian example, where new money laundering legislation involving considerable domestic regulatory restructuring has been introduced through the recommendation of foreign states during the mutual evaluation procedure of the FATF. Canada was found lacking in 1997 in two areas: the lack of mandatory reporting of suspicious transactions (e.g. deposits of large sums of cash, or transfers or deposits of sums uncharacteristic of the client's normal activity), and the control of cross-border movement of currency.

In this example, domestic legal reforms were initiated almost entirely through initiative from outside the state. Yet by complying, Canada ensured that the norms upheld by the regime obtained greater effectiveness, and Canada itself will doubtless benefit from the strength of those norms in the future. In short, the days of complete legal and economic autonomy are over, for any state wishing to survive in the modern economy. The principles of reciprocity, through mutual legal assistance, adherence to international standards, and other means, allow a degree of confidence that the sacrifice of a portion of our sovereignty yields greater gains for the rule of law.

Secondly, many of the papers presented suggest the importance of the role of technical specialists in international co-operation. As highlighted by Joseph Myers of FinCEN, most of the progress in international co-operation against financial crimes, whether at the FATF, the United Nations, the Council of Europe, or the OAS, has been made not by senior diplomats, but by technical specialists. The reasons for this are fairly obvious. The challenge of financial fraud is technically sophisticated, and our collective solution must be equally sophisticated. Politicians and senior policy makers are often unable or unwilling to grasp the complexities involved, and they have wisely chosen to delegate the development of policy to a set of dedicated specialists with various backgrounds, including the legal profession, policing, financial professions and financial institutions. Many of the experts at events such as the current Symposium come from that group, and they will re-gather in the coming years in many different international negotiating sessions. The strength of this technocratic 'epistemic community' in pushing the agenda of legal and regulatory reform is marked. Accordingly, for China, as for other countries, the value of having a corps of professional and technical specialists dedicated to negotiating international co-operative arrangements on financial fraud cannot be overstated if China is to participate fully in the evolution of the international regime combating financial crimes.

Conclusion

China faces a unique challenge in confronting domestic and international financial fraud in the midst of its own economic transition. This challenge has no genuine precedent in the West, and thus China is in many ways a laboratory for the effective control of the darker sides of unfettered commerce. In facing this challenge, China will benefit in joining other countries in the search for cost-effective strategies to combat financial fraud. Many of the more useful strategies already identified have been listed in this paper, but China's unique situation and particular economic characteristics suggest that this list cannot be exhaustive. Indeed, things may need to get worse (and thus patterns of abuse more identifiable) before they get better and indigenous solutions are developed. Finally, China, along with Canada, the United States, and other countries, must deal with fact that progress will be impossible without a commitment to international co-operation. All of us must accept the sacrifices that that commitment entails.