Protecting Financial Market Integrity

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Protecting Financial Market Integrity

Roles and Responsibilities of Auditors

Inaugural lecture, addressed in free format at the occasion of formally accepting the chair of Professor in 'Compliance and Risk Management in the Financial Sector' on behalf of the Foundation '*Compliance en Toezicht*' and enabled with active support of ABN AMRO Bank NV

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To Petra, Robin and Rogier
'Remain Independent'

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1 Introduction

Why do people deposit their money in a bank?

This is a basic question and maybe one which is too simple to ask. Since the 1960s, almost all individuals in the Western world have one or more bank account(s). It is not unusual that grand-parents open a bank account for their new-born grand children resulting in the fact that many already have a bank account while being completely unaware of it. We deposit our savings in bank accounts, we trust banks to manage our financial assets and we borrow money to finance our needs both from a private as well as from a business perspective. The array of services provided by banks vary from very simple saving accounts to more complex business accounts to very complex financial products in international business.

Like every industry, the banking industry has a 'licence-to-operate', which is solely based on the trust that we have in this industry. Trust is needed because the total amount that we have in our bank accounts exceeds widely the amount of cash available in the market. In this respect, banks play a fiduciary role in the economy. People 'believe' and should continue to believe that the bank will honour payment instructions at all times. The bank should always be in a position to have sufficient 'solvency'[1] to honour all debts at all times. The amount of minimum capital needed to honour all liabilities is a function of the bank's risk profile, where 'risk' is a combination of many different risk types. The most important risk types are credit risk, market risk, operational risk, liquidity risk, interest rate risk and reputation risk.

Integrity of the financial market is essential for maintaining and sustaining the license-to-operate for institutions in this sector. The abuse of the financial system by criminals and terrorists may severely impair the sector's integrity. Money laundering and terrorist financing are an important threat

1. Solvency is the proportion of capital that the bank retains on its balance sheet in relation to total assets and risk exposure.

to the integrity of financial markets. Although it is not easy to make an accurate calculation of the financial magnitude of money laundering and terrorist financing, Unger *et al.* indicate that the magnitude is not insignificant based on assumptions made by the International Monetary Fund. She indicates that the magnitude may be as large as US$ 2.85 trillion per year.[2] According to the Ministry of Finance in February 2006, the magnitude of money laundering in the Netherlands is estimated to be approximately EUR 18.5 billion annually of which approximately EUR 14.7 billion originates from foreign illicit activities and the remainder EUR 3.8 billion originates from domestic crime.[3] Keeping this amount in mind, it is unmistakable that financial institutions are affected. Only through the network of banks, amounts of this magnitude can flow around the globe.

Banks play a pivotal role in the economy and without the banking function the economy would be completely paralysed. This is why the banking industry is a so-called 'regulated industry' in almost all countries in the world. In most countries there is one regulatory authority for the banking industry, namely the Central Bank. In the Netherlands, there are two prominent regulatory authorities: the Dutch Central Bank (further: DNB) which is responsible for prudential supervision[4] of the banking industry and the Authority of Financial Markets (further: AFM), which is responsible for integrity or behavioural supervision. The main purpose of banking supervision is to ascertain that banks have appropriate policies and procedures in place to make adequate risk analyses and take timely action if and when risk levels exceed the limits set by management. Furthermore, it is essential that management remains in-control of the risk, which means that risk is being managed and kept within certain ranges. This is not to state that banks should avoid risk, but that they accept a level of risk that is consistent with management's risk appetite. Because banks are in the risk business they make money and create shareholder value. However, management should constantly be aware of the fact that banks are vulnerable to abuse of their systems by criminals. Managing and controlling reputation risk are therefore essential parts of risk management and central points of focus in regulatory supervision.

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2. Unger, Prof. Dr. Brigitte *et al.*, *The Amounts and Effects of Money Laundering, Report to the Ministry of Finance*, 16 February 2006.
3. *See* http://www.minfin.nl/nl/actueel/nieuwsberichten,2006/02/witwassen_in_nederland-_geschat_op_18x5_miljard_euro_per_jaar.html.
4. Prudential supervision is predominantly focused on the economic soundness of the bank and its capital adequacy.

Protecting the financial markets from abuse by criminals is only one aspect. It is a so-called external risk of abuse. However, the protection of the financial market integrity also has an internal aspect. This is aimed at the internal governance of financial institutions. Without appropriate internal controls and good corporate governance, financial institutions are vulnerable and may easily loose reputation as a result of incidents that can occur due to weaknesses in internal controls. In order to preserve reputation, financial institutions must take appropriate measures to avoid insider trading by management and staff, to avoid misuse of privileged information through so-called 'Chinese Walls' between trade desks on one hand and financial analysts as well as client relationship bankers on the other hand and they must ensure the credibility of management and staff through screening of integrity sensitive positions.

This inaugural address is focused on protecting the integrity of financial markets. A certain emphasis is placed on law and regulation to avoid the risk of market abuse by criminals. The role and responsibility of auditors as prescribed in law and regulation will be highlighted. However, it should be clear that auditors also play an important role in assessing the internal controls and corporate governance of financial institutions and hence have a role in avoiding the internal risk of loss of reputation. Furthermore, pursuant to prevailing law and regulation, auditors do have an information and reporting duty to the regulatory authorities and hence are an important source of information for the regulators.

The integrity of the financial markets is not solely the responsibility of banks, but of financial institutions more in general, which encompass other businesses in the financial sector as well such as insurance companies, pension funds, intermediaries, clearing houses etc. However, I will concentrate on banks more in particular. Secondly, integrity of financial markets is not only a matter of personal behavioural aspects of management and staff. Integrity of the financial market is a combined function of capital adequacy resulting from proper risk management, corporate governance, internal controls and personal integrity of management and staff in concert with sound supervision of the industry by regulatory authorities.

This inaugural address will start with the European legislative framework to ascertain financial market integrity. The first regulations date back to the end of the 1980s and resulted in European Union (further: EU) directives and adjustment of the laws of EU Member States during the 1990s and into

this decennium. In spite of EU efforts, an American 'think tank' chaired by Maurice R. Greenberg *et al.* is quite pessimistic about the EU scrutiny regarding the global combat against money laundering and the financing of terrorism.[5] The question is really whether EU lawmaking and focus on the financial markets is indeed substandard.

Being an economist and auditor myself, I will not make judicial judgments nor make legal analyses. I will summarise laws and regulations promulgated by the EU and some supranational financial institutions such as the Bank for International Settlements and the Committee of European Banking Supervisors. I will briefly touch on the current Dutch legislation, in particular the Law on Financial Supervision ('Wet op het financieel toezicht') and the Law on Unusual Transaction Reporting ('Wet MOT') as well as the Law on Identification with Services ('WID'). While discussing these laws and regulations, I will highlight the role of auditors or the audit function in the context of safeguarding the integrity of the financial market.

5. Greenberg, Maurice R. *et al.*, *Terrorist Financing, Report of an Independent Task Force Sponsored by the Council of Foreign Relations*, New York, 2002.

2 Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT)

2.1 Money laundering

Money laundering is a financial engagement with the purpose to conceal the origin of the money and to make it appear legitimate and as such enabling the investment of the money in the economy. In order to make money laundering successful, the first objective is to place the money into the financial banking system in a way that the true origin is disguised. In the early 1980s, the main source of money laundering was the proceeds from drug trafficking and drugs dealing. However, all kinds of illegal activities may generate illicit financial proceeds that give rise to the need to launder the money prior to investing the results in the economy.

An essential hypothesis is that criminals act in an economic rationale way. This means that they normally wish to make a return-on-investment on the profits from illegal and criminal activities. Given the size of illegal money, criminals may also engage in a rather exhibitionistic lifestyle, but in essence it is hypothesised that they want to maintain a source of income from the illicit proceeds of their criminal activities. One way of realising a return-on-investment is to re-invest the illicit profits in business enterprises and try to make the appearance of the funding for these investments as normal and legitimate as possible.

Certainly in the time of drugs trading, much of the financial proceeds were in cash. In one way or another, this cash had to be deposited on a bank account. In 1970, the US Administration, in its war against drugs, mandated that any cash transactions in excess of US$ 10,000 had to be reported to the authorities by way of a 'suspicious activity report'.[1] This may have been the first formal attempt to combat money laundering although this was not yet formally criminalised. Meanwhile, this monetary threshold has been set at EUR 15,000 in Europe.

1. Bank Secrecy Act of 1970, formally enacted as the 'Bank Records and Foreign Transactions Act'.

In the process of money laundering, three stages are normally distinguished i.e.:

- placement;
- layering;
- integration.

Placement is the act of depositing money into the financial system. There are various ways of placing the money into the system, such as by way of 'smurfing'. Smurfing is depositing small amounts (under the threshold of US$ 10,000 / EUR 15,000) into different banks and on different bank accounts. Once the money is credited on the bank accounts, the beneficiary is in a position to transfer the money to virtually any place in the world by way of internet banking or wire transfer.

Larger amounts of money can be deposited on bank accounts in countries and territories with a lack of anti-money laundering legislation, procedures and/or supervision. Given the sheer size of illicit money floating around the world, criminals may use means of threat, pressure or violence to place the money on a bank account while trying to avoid that 'suspicious activity reports' be sent to the authorities.

The second stage of money laundering is layering, which is engaging in a number of (consecutive) financial transactions with the aim to obscure the link between the money and its origin. The financial transactions have the purpose to create a very convoluted scheme of money transfers to various bank accounts in various names in different countries in the world. By creating chaos and convolution, it becomes increasingly difficult to trace the flow of funds to its origin, which hampers law enforcement and investigators to prove that this origin is indeed illegal. However, this is not only a risk for law enforcement, but also for the banking industry. Banks which are involved in a 'later stage' will have increasing difficulty to ascertain the (il)legality of the source of funds and the source of wealth. Because, the illegality cannot be proven, which is exactly the purpose of layering, bank accounts are opened and clients are accepted whereas in reality, the funds are derived from illegal origin and the clients would not fit the reputation criteria set by the bank.

Once the layering is completed, the money, which now *appears* to be derived from *legal* sources, can be reinvested into business enterprises. This is the stage of integration. Because criminals do not want to attract too much attention, these business enterprises appear perfectly normal. There are accounting systems, proper records, tax returns, charters and good governance. In reality, these enterprises are conduits or 'faade companies' hid-

ing the illegal activities that take place behind the scene. On the other hand, the apparently 'normal' businesses are run by criminals or criminal organisations and as such have a negative effect on the integrity of the business community in particular and on the integrity of the society at large.

2.2 Terrorist financing

The terrorist attacks on the World Trade Centre, New York and the Pentagon, Washington DC in September 2001, started an international combat against the financing of terrorism. Shortly after the attacks, the UN Securities Council issued a resolution calling states to collaborate in the combat against terrorism and decided that states will prevent and suppress the financing of terrorism[2]. In the same resolution, the Security Council criminalised all means to support terrorism and decided to freeze all financial means without delay.

In October 2001, the Financial Action Task Force (further: FATF) issued eight special recommendations to counter terrorist financing.[3] In 2004, these recommendations were updated and a ninth recommendation was added to the list.

Whilst terrorist financing is distinguished as a predicate offence, FATF specialists found that the means of terrorist financing do not differ materially from the means used for the financing of other criminal acts.[4] FATF defined terrorism as an act which is intended to create fear (terror), is perpetrated for an ideological goal (as opposed to a lone attack), and deliberately target or disregard the safety of civilians. Many definitions also include only acts of unlawful violence and acts of war. According to FATF (2001-2002), the objective of terrorism is to intimidate a population, or to compel a Government of an international organisation to do or abstain from doing any act.[5]

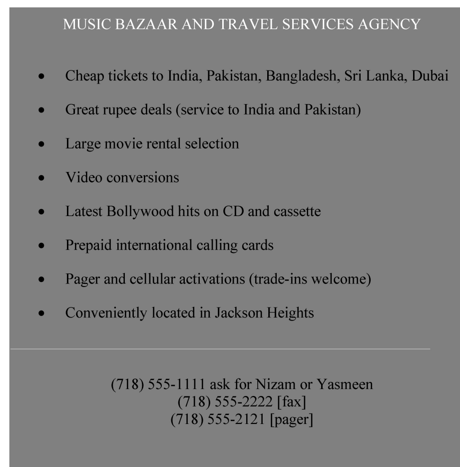
According to FATF, there are two main sources for funding terrorism. In the first place, terrorism can be funded by States and wealthy individuals. FATF does believe that State sponsored financing of terrorism has declined over the past years and has been superseded by backing from other sources.[6] The second source of income for terrorism may come from 'revenue generating' activities. These activities can both be legal and illegal in nature.

2. United Nations Security Council, Resolution 1373 (2001) of 28 September 2001.
3. *See* http://www.fatf-gafi.org/document/9/0,3343,en_32250379_32236920_34032073_1-_1_1_1,00.html.
4. FATF, Report on Money Laundering Typologies 2001-2002, February 2002.
5. For the definition of terrorism used by the EU, *see* paragraph 3.3.
6. FATF 2002, p. 2.

For example, financing may come from kidnapping and extortion and it may come from fund raising activities by charities, political or religious groups. Once the funds are generated, the money should be laundered in an attempt to disguise the authorities or at least to avoid attention from that side. Some of the particular methods mentioned by experts in connection with various terrorist groups include: cash smuggling (both by couriers or bulk cash shipments), structured deposits to or withdrawals from bank accounts, purchases of various types of monetary instruments (travellers' cheques, bank cheques, money orders), use of credit or debit cards, and wire transfers. There have also been indications that some forms of underground banking have had a role in moving terrorist related funds.[7]

2.3 Hawala banking

Hawala Banking is also known as 'underground banking' or transmitting money without moving money. According to Jost and Shandu,[8] hawala banking is an alternative remittance system and the classification as 'underground banking' is not always justified as the system is widely and openly advertised in many Western countries as is illustrated by the advertisement which can be found in many American newspapers.



Source: Jost *et al*, (2000)

7. Ibid p. 4-5.
8. Jost, Patrick M., Harjit Singh Sandhu, *The hawala alternative remittance system and its role in money laundering*, Interpol General Secretariat, Lyon, January 2000.

Although, the second bullet does not specifically state that the persons mentioned are bankers (called: hawaladas), it is a typical announcement for such services.

Hawala banking is a remittance system originated from India and Pakistan and it exists next to alternative systems originating from other countries. For hawala banking to be successful, three components are necessary i.e.:
- trust;
- network;
- clearing system (record keeping).

The system is used to transmit money, usually between countries. It is widely used by Indian or Pakistani workers in the Western world for transmitting money to their families at home. For these workers there are basically two possibilities to transmit money. Either they transmit funds by using a Western bank or they make use of the hawala system. Based on their investigations, Jost *et al.* (2000) state that Indians and Pakistani in many cases rely more on the hawala system than on Western banking. Vaknin states that 'Hawala consists of transferring money (usually across borders and in order to avoid taxes or the need to bribe officials) without physical or electronic transfer of funds'.[9] The fact that taxes and also bribe may be avoided is a good reason for people to choose for the hawala system. The transmission of funds usually takes one day and the only consideration is that there is a rather lengthy time zone difference between the Western World on one hand and Pakistan and India on the other hand.

Hawala banking works with hawaladas on either side of the transmission i.e. one hawalada in the Western world and a counterpart in Pakistan or India. These two hawaladas form part of a network. In many cases the network consists of family relationships or close relatives and friends. It is also possible that the network consists of business partners. That is why hawala banking is sometimes an off shoot of an import/export business.

Finally, it is necessary to maintain accounting records i.e. a clearing system with debits and credits. This can best be explained with an example (derived from Jost *et al.* (2000)):

> A Pakistani wishes to transmit US$ 5,000 from New York to his family in Pakistan. He chooses to transmit the funds through the hawala system. The hawalada offers him

9. Vaknin, Sam PhD, 'Hawala, the Bank that never was', http://www.executivecoachingstudio.com/hawalanever.htm.

35 Rp/$ and a fee of Rp 1 for each dollar. Based on this, the Pakistani can transmit Rp 170,000 to his family (Rp 175,000 minus Rp 5,000 for the fee).

The New York hawalada now has a deposit of US$ 5,000 and a liability of Rp 170,000 to the counterpart in Pakistan. This can be cleared in different ways. Firstly, if the New York hawalada does import/export business, an amount of US$ 5,000 can be discounted on an invoice to the counterpart in Pakistan. It is also possible that the New York hawalada has a large amount of Rupees in Pakistan, which cannot be transmitted to the US because of foreign exchange restrictions. By engaging in hawala banking, the Rupees are gradually exchanged for US Dollar, while avoiding foreign exchange restrictions.

Analysing the hawala banking system, it becomes clear that all components of traditional Western banking do exist. There must be trust, there is a network and there are accounting records. In traditional Western banking, the network exists in the form of correspondent and respondent banking relationships and records are kept in form of nostro and loro accounts, which is basically exactly the same as the record keeping system in the hawala system.

The only one and probably major difference between traditional Western banking and hawala banking is that the latter is executed under the radar screen of regulatory authorities. Because there is no regulatory supervision, there are no official statistics indicating the volume of hawala banking and it makes the hawala system more vulnerable for abuse by criminals and terrorists. This is why the hawala system is sometimes called 'a banking system built for terrorism'.[10] However, if the total amount of illicit money is taken into consideration, it is inconceivable that all of this money flows through hawala or alternate systems. In other words: also the traditional Western banking system is affected by the flow of illicit funds.[11]

In a recent study by David Seddon,[12] it is indicated that there is massive growth of money transmissions, but that it is still difficult to measure the transmissions accurately because of diverting definitions used in the official statistics of many countries. According to this study, the global remittance

10. Ganguly, Meenakshi, 'A Banking System Built for Terrorism, – Time in partnership with CNN', 5 October 2001, *see* http://www.time.com/time/world/printout/0,8816,178227,00.html.
11. For a brief description of Malaysian money changers, *see* Vlcek, William, *European measures to combat terrorist financing and the tension between liberty and security*, London School of Economics, September 2005, p. 16.
12. Seddon, David, Informal money transfers: Economic links between UK diaspora groups and recipients 'back home', Centre for the Study of Financial Information, November 2007.

flow amounts to approximately US$ 200 billion. According to Seddon, in the aftermath of the September 2001 events, there is indeed growing concern about the financing of terrorism. Whilst there was a tendency of relaxation of foreign exchange controls in the EU in the 1970s and 1980s, the pressure to formally regulate the transmissions of money has increased considerably after 9/11. However, there is still no regulatory system that ensures supervision and statistical record building of global informal remittances.

2.4 **Legislative initiatives**

Since many years there is growing international attention for the integrity of financial markets. The Dutch legal and regulatory initiatives in this area cannot be looked at in isolation; they form part of similar developments in the international arena. An important historic milestone in the fight against abuse of the financial system was the development of 40 Recommendations by the FATF[13] in 1990. The FATF was founded in 1989 by the G-7 countries to develop anti-money laundering strategies. The 40 Recommendations pertain to three main areas i.e. the legal system, financial institutions and institutional measures. They provide a complete set of counter-measures against money laundering and have been recognised, endorsed, or adopted by many international bodies. Regarding the legal system, the core recommendations pertain to the need to arrive at a legal framework against money laundering and to criminalise money laundering in its own right. According to FATF, financial institutions have to establish policies and procedures to 'know your client' (further: KYC) and to report suspicious activities by clients to financial intelligence units. The well known acronym 'KYC' is directly derived from the 40 FATF Recommendations. Finally, in respect of institutional measures FATF recommends that enhanced international collaboration between governments take place and that States enter into bilateral and multilateral treaties to facilitate seizure and forfeiture of illicit proceeds of money laundering.

Following the money laundering scandal in which Bank of Credit and Commerce International was involved, the American Administration enacted the Annunzio-Wylie Anti-Money Laundering Act 1992. This act, which is nick-named 'bank death penalty', gives bank regulators the power to order

13. *See* http://www.fatf-gafi.org/pages/0,2987,en_32250379_32235720_1_1_1_1_1,00.html.

a bank that has been convicted of a money laundering offence to cease operations.[14]

Another international initiative, which took place in 2000, is the establishment of The Wolfsberg Group, which is an association of twelve international banks and an NGO[15] aimed at developing financial services industry standards, and related products, for KYC, Anti-Money Laundering (further: AML) and Counter Terrorist Financing policies. Whilst most legislation is prepared and enacted in the public domain by legislators, the Wolfsberg Group is a private initiative which has resulted in issuing eleven anti-money laundering principles in 2000, which were revised in 2002. It should be noted that the Wolfsberg Principles apply to private banking activities rather than the comprehensive set of banking services. However, banks are encouraged to apply the Wolfsberg Principles in each of their legal entities and subsidiary companies, in particular in countries with a known lack of anti-money laundering or banking supervision system. Following the eleven principles for private banking, the Wolfsberg Group has issued six new statements on various issues such as principles for correspondent banking, screening and searching, and managing money laundering risks.

It is quite obvious that the events of 11 September 2001 have accelerated the enactment of laws and regulations to protect the financial system from being abused in general and for financing terrorist activities in particular. Since the events of September 2001, regulatory requirements for the financial industry have strengthened significantly. In the first place, shortly after the September 2001 events, the American Administration enacted the so-called USA PATRIOT ACT of 2001 on 26 October 2001. The act may be cited as the 'Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT of 2001)'. More in particular Title III of this act[16] is aimed at combating money laundering and terrorist financing. In the act, reference is made to the global magnitude of money laundering. The global flow of illicit cash is the primary source of financing of terrorist and illegal or fraudulent activity. The main purpose of the act is to protect society against the negative effects of terrorist, illegal and fraudulent activity through broadening the abilities of

14. Hinterseer, Kris, 'The Wolfsberg Anti-Money Laundering Principles', *Journal of Money Laundering Control*, Vol. 5, No. 1, Summer 2001, p. 25-41.
15. The twelve banks are: Deutsche Bank, Société Générale, ABN AMRO, Credit Suisse, UBS, HSBC, Barclays, Banco Santander, Citybank, JP Morgan Chase, Goldman Sachs, Bank of Tokyo. Furthermore, Transparency International is a member of the group.
16. Title III is titled: International Money Laundering abatement and Anti Terrorist Financing Act of 2001.

various US federal agencies and by enforcing strengthened oversight over the financial markets. Article 352, sub 1 (D) states that an independent audit forms part of the anti-money laundering programmes that have to be established by banks. The law is unclear whether this audit can be performed by an internal audit department that is independent from the compliance department or that it must be carried out by the institution's external auditor. In the remainder of this Act, the explicit role of external or internal audit in the combat against money laundering and terrorist financing is not highlighted.

Even though the events of 11 September 2001 had a major impact on law making and issuing of new regulations, also prior to this date there was substantial attention and law making aiming at protecting the integrity financial markets. On a multilateral level, the United Nations have issued a number of resolutions aiming at curtailing money laundering. The most important resolutions can be summarised as follows:[17]

United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (1988, the Vienna Convention)
The Vienna Convention, as it is commonly known, deals primarily with the illicit drug trade and related law enforcement issues. It is the first UN Convention to define the concept of 'money laundering', even though it does not use that term, and it calls on countries to criminalise the activity. This convention is limited, however, to drug trafficking offences and does not address the preventative aspects of the crime.

The International Convention against Transnational Organised Crime (2000, the Palermo Convention)
This convention contains a broad range of provisions to fight organised crime. With respect to money laundering, it requires countries to criminalise money laundering and include all serious crimes as predicate offences of money laundering (not just drug-related offences), plus permit the required criminal knowledge or intent to be inferred from objective facts, not proven individually;

- establish regulatory regimes to deter and detect all form of money laundering;
- authorise domestic and international co-operation and exchanges of information among administrative, regulatory, law enforcement, and other types of authorities;
- promote the establishment of governmental units to centrally collect, analyse, and disseminate information.

International Convention for the Suppression of the Financing of Terrorism (1999)
This convention requires countries to criminalise terrorism, terrorist organisations, and terrorist acts. Under this convention, it is unlawful for any person to provide or collect

17. *Financial Sector Assessment, A Handbook,* The Worldbank and the International Monetary Fund, Washington DC, 2005, Chapter 8.

funds with the intent or knowledge that the funds will be used to carry out any defined acts of terrorism.

Security Council Resolution 1373
This resolution obligates all countries to criminalise actions to finance terrorism. This resolution also obligates countries to deny all forms of support to terrorist groups and to freeze assets of those involved in terrorist acts. It also encourages co-operation among countries for criminal investigations and for sharing information about planned terrorist acts.

Security Council Resolution 1267 and its Successors
Security Council Resolution 1267 required all countries to freeze the assets of the Taliban and entities owned or controlled by them, as determined by the 'Sanctions Committee'. Later, Resolution 1333 added the assets of Osama bin Laden and al-Qaeda to the freezing list. Subsequent resolutions established monitoring arrangements (Resolution 1363), merged earlier lists (Resolution 1390), provided some exclusions (Resolution 1452), and improved implementation measures (Resolution 1455). Together, the various lists for freezing assets are maintained and updated by the '1267 Committee' and are published on the UN's website.

The Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS), and International Organisation of Securities Commissioners (IOSCO) have each issued broad supervisory standards and guidelines on a wide range of supervisory issues, including money laundering as it relates to banking, insurance, and securities. The initiatives taken by IAIS and IOSCO are summarised below:[18]

IAIS
This association has issued its Guidance Paper 5, 'Anti-Money-Laundering Guidance Notes for Insurance Supervisors and Insurance Entities', which parallels the Basel Committee's statement on prevention. It contains four principles that should be embraced by insurance entities:
- comply with anti-money-laundering laws;
- have know-your-customer procedures in place;
- co-operate with all law enforcement authorities;
- have internal anti-money-laundering policies, procedures, and training programmes for employees.

IOSCO
This organisation passed its 'Resolution on Money Laundering' to be implemented by securities regulators in individual countries. It consists of seven specific areas for securities regulators to consider in establishing requirements for firms under their jurisdiction:
- the extent of customer identifying information with a view towards enhancing the ability of authorities to identify and prosecute money launderers;

18. Initiatives taken by the BCBS will be described in Chapter 4.

- the adequacy of record-keeping requirements to reconstruct financial transactions;
- whether an appropriate manner is used to address the reporting of suspicious transactions;
- what procedures are in place to prevent criminals from obtaining control of securities businesses and to share information with foreign counterparts;
- whether means are appropriate for monitoring compliance procedures designed to deter and detect money laundering;
- the use of cash and cash equivalents in securities transactions, including documentation to reconstruct transactions;
- whether means are appropriate to share information to combat money laundering.

The question is to what extent these international resolutions have a direct effect on the accountability and liability of companies. Bleker[19] indicated that whilst the subject of 'international law' is extremely complex, legal accountability for companies as a result of international law has increased over time. As a result of the growing globalisation of the economy there is a trend to enter in an increasing number of international treaties and resolutions. However, many states are reluctant to decrease their sovereignty in exchange for more power by international bodies. There are two exceptions, i.e. the EU and the United Nations. These two international bodies do have legislative power, based on which Member States have to adjust their own laws. Regulations promulgated by these two bodies may therefore have a more direct impact on business organisations.

19. Dr. S.C. Bleker-van Eyk, 'Internationale bestrijding van witwassen, terrorisme en corruptie', in: *Handboek Compliance 2003*, p. 105-122, Kerckebosch, 2003.

3 EU Legislation

3.1 Recommendation R(80)10 and Convention 141

Within the EU (*see also* Vlcek, 2005), Recommendation R(80)10 of 27 June 1980 *'On measures against the transfer and the safekeeping of funds of criminal origin'* was one of the first multilateral initiatives to protect the financial system from being abused for criminal or terrorist means. In this recommendation, the committee of ministers makes the recommendation to Member States that their governments:

'a. arrange for the following measures to be taken by their banking system:
   i. identity checks on customers whenever:
      - an account or a securities deposit is opened;
      - safe-deposits are rented;
      - cash transactions involving sums of a certain magnitude are effected, bearing in mind the possibility of transactions in several parts;
      - inter-bank transfers involving sums of a certain magnitude are made, bearing in mind the possibility of transactions in several parts.

      These checks must be made on the basis of an official document or, where the relationship with the customer has been established through correspondence or through a third party, by equivalent means;
   ii. rental of safe-deposits only to persons or firms with whom the bank has already had dealings over a certain period or whom the bank can regard as trustworthy on the strength of references;
   iii. constitution of reserve stocks of banknotes whose serial numbers are made known to the authorities if the banknotes have been used in connection with criminal offences;

iv. suitable training for cashiers, particularly in checking identity papers and detecting criminal behaviour;

b. establish close national and international co-operation, inter alia with the help of Interpol, between banks and the appropriate authorities in exchanging information about the circulation of banknotes which have been used in connection with criminal offences and in following their movements;

c. set up machinery enabling banks, either by systematic comparison or by spot-checks, to refer to the list of banknotes used in connection with criminal offences when notes are paid in.'[1]

Following Recommendation R(80)10, the Member States of the Council of Europe agreed on the European Convention No. 141 *'Convention on laundering, search, seizure and confiscation of the proceeds from crime'* (further: Convention 141) which was issued on 8 November 1990 and entered into force on 1 September 1993.[2] The foundation for this convention was laid during the meeting of European Ministers of Justice at a conference in Oslo, Norway on 17-19 June 1986. During this conference the ministers discussed ways to smash the drugs market, which was often linked with organised crime. In order to achieve this main objective, the convention considered that international co-operation was a prerequisite. For this international co-operation to be effective, it was deemed necessary to arrive at shared concepts and principles of law. However, it was also considered that Member States' legislation differed widely, which might easily impair international co-operation. Another main purpose of the convention was to complement already existing instruments, drawn up within the framework of the Council of Europe. In this respect, complementing existing instruments is meant to be mutual assistance in criminal matters and enhanced investigative assistance between 'judicial' authorities in areas such as asset tracing. Co-operation between police authorities for the same purpose would normally not be covered by the terms of the convention.[3]

The main purpose of Convention 141 was to enhance international collaboration between states with regard to investigative assistance, search, seizure and confiscation of proceeds from all types of crime which normally

1. Council of Europe, Committee of Ministers, Recommendation R (80) 10, adopted by the Committee of Ministers on 27 June 1980 at the 321st meeting of the Ministers' Deputies.
2. *See also* Mul V., *Banken en Witwassen*, Sanders Instituut 1999 (Diss. EUR), p. 48-53.
3. Council of Europe, Convention No. 141 'Convention on laundering, search, seizure and confiscation of the proceeds from crime', *Explanatory Report*, paragraph 8-9.

generate large profits. In arriving at the final wording of the Convention 141, the United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances of 1998[4] has played an important role. Article 2, paragraph 1 of the convention, calls for international collaboration in the fight against drugs and psychotropic substances. Further measures such as confiscation are dealt with in Article 5 of the convention. According to the convention, confiscation applies for:

a. Proceeds derived from offences established in accordance with Article 3, paragraph 1, or property the value of which corresponds to that of such proceeds;
b. Narcotic drugs and psychotropic substances, materials and equipment or other instrumentalities used in or intended for use in any manner in offences established in accordance with Article 3, paragraph 1.

3.2 The need for a broader scope

Whilst the 1988 UN Convention played an important role as a basis for Convention 141, its scope was limited to the combat against illicit proceeds from trading in drugs and psychotropic substances. Clearly, the combat against money laundering and the abuse of the financial system in general, warrants a much broader scope than the one provided for in the 1988 UN Convention. Furthermore, as a result of a changing environment in the combat against money laundering and financial crime during the 1990s, Convention 141 was revised and ultimately reissued as Convention 198 on 16 May 2005. Although, Convention 198 was renewed in order to closely respond to the changed environment of financial crime and the financing of terrorism, the fundamental principle of Convention 141 remained untouched. This principle is ‘to provide a complete set of rules, covering all the stages of the procedure from the first investigations to the imposition and enforcement of confiscation sentences and to allow for flexible but effective mechanisms of international cooperation to the widest extent possible in order to deprive criminals of the instruments and fruits of their illegal activities’.[5]

4. United Nations, Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, Vienna, 1988.
5. Council of Europe, Convention No. 198 ‘Convention on laundering, search, seizure and confiscation of the proceeds from crime and on the financing of terrorism’, 16 May 2005, Explanatory Report, paragraph 5.

Between 1990 and 2005 much changed in the environment of money laundering as well as the law enforcement thereof within the EU, which gave rise to revising Convention 141 and compiling Convention 198. In the first place, much experience had been gained following various evaluations of the FATF 40 Recommendations. Initially developed in 1990, the recommendations were revised for the first time in 1996 to take into account changes in money laundering trends and to anticipate potential future threats. More recently, in 2003, the FATF has completed a thorough review and update of the 40 Recommendations. The FATF has also elaborated on various Interpretative Notes which are designed to clarify the application of specific recommendations and to provide additional guidance.[6] Furthermore, pursuant to the events of 11 September 2001, the FATF came out with initially eight and later nine special recommendations focusing on the combat against financing of terrorism.[7] In December 2001, the European Directive of June 1991 on the prevention of the use of the financial system for purposes of money laundering was substantially adjusted.[8] Among the reasons to adjust the 1991 EC Directive in 2001 was the need to clarify which state authority should receive and act upon so-called suspicious activity reports (further: SAR) from branches of financial institutions having the head office in another state. Further there was a need for clarification which state authority had responsibility to ensure that branches of financial institutions comply with the Directive. In addition to these adjustments, it was considered that certain financial service providers such as 'currency exchange offices' and 'money transmitters' were particularly vulnerable to money laundering and that these service providers had to be brought into the scope of the Directive. Another important reason to adjust the 1991 EC Directive in 2001 was the limited scope of the 1991 Directive. In fact, the scope of this directive was to combat the laundering of proceeds from drugs offences. Clearly, this was in line with the 1988 UN Vienna Convention. However, it became clear that a much wider definition of money laundering had to be applied. Money laundering takes place based on a broader range of underlying or predicate offences than just drugs offences.

For the same reason, the FATF revised the 40 Recommendations. In Recommendation 1, the FATF defines the scope of money laundering and

6. FATF, The 40 Recommendations, 1990, revised in June 2003, *see* http://www.fatf-gafi.org/pages/0,2987,en_32250379_32235720_1_1_1_1_1,00.html.
7. FATF, Special Recommendations on Terrorist Financing, http://www.fatf-gafi.org/document/9/0,3343,en_32250379_32236920_34032073_1_1_1_1,00.html.
8. EU, Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001.

reference is made to the 1998 UN Vienna Convention and the 2000 UN Convention against Transnational Organised Crime (Palermo Convention), more in particular Article 6 and 7 of the convention.[9] In the legislative guide to this convention,[10] the broad scope is defined as follows:

'(a)(i) The conversion or transfer of property, knowing that such property is the proceeds of crime, for the purpose of concealing or disguising the illicit origin of the property or of helping any person who is involved in the commission of the predicate offence to evade the legal consequences of his or her action;
(ii) The concealment or disguise of the true nature, source, location, disposition, movement or ownership of or rights with respect to property, knowing that such property is the proceeds of crime;
(b) Subject to the basic concepts of its legal system:
(i) The acquisition, possession or use of property, knowing, at the time of receipt, that such property is the proceeds of crime;
(ii) Participation in, association with or conspiracy to commit, attempts to commit and aiding, abetting, facilitating and counselling the commission of any of the offences established in accordance with this article.'

In the first of the 40 Recommendations, FATF recommends that money laundering be criminalised as a predicate offence.[11] Predicate offences may be described by reference to all offences, or to a threshold linked either to a category of serious offences or to the penalty of imprisonment applicable to the predicate offence (threshold approach), or to a list of predicate offences, or a combination of these approaches.

9. United Nations, Convention against Transnational Crime, General Assembly Resolution 55/25 of 15 November 2000.
10. United Nations, Legislative guides for the implementation of the UN Convention against Transnational Organised Crime and the protocols thereto, New York, 2004, p. 36-37.
11. For the definition of 'predicate offences' FATF makes reference to the category of serious offences under national law which are punishable by imprisonment of more than one year or for those countries that have a minimum threshold for offences in their legal system, predicate offences should comprise all offences, which are punished by a minimum penalty of more than six months imprisonment.

3.3 **Council Regulation 2580/2001**

Shortly after the terrorist attacks of 11 September 2001, the Council of Europe gathered in an extraordinary meeting on 28 September 2001 and issued Council Regulation 2580/2001.

According to this resolution, the EU Council stated that combating the funding of terrorism is a decisive aspect of the fight against terrorism and called upon the Council to take the necessary measures to combat any form of financing terrorist activities. Further, the Council referred to United Nation Security Council Resolution 1373(2001), in which the United Nations Security Council decided that all States should implement a freezing of funds and other financial assets or economic resources against persons who commit, or attempt to commit, terrorist acts or who participate in or facilitate the commission of such acts.

The EU Council referred to a position paper i.e. the Council common position of 27 December 2001.[12] In this common position paper, the EU Council defined terrorism in Article 1, paragraph 3 as follows:

> 'For the purposes of this Common Position, "terrorist act" shall mean one of the following intentional acts, which, given its nature or its context, may seriously damage a country or an international organisation, as defined as an offence under national law, where committed with the aim of:
> (i) seriously intimidating a population, or
> (ii) unduly compelling a Government or an international organisation to perform or abstain from performing any act, or
> (iii) seriously destabilising or destroying the fundamental political, constitutional, economic or social structures of a country or an international organisation:
> (a) attacks upon a person's life which may cause death;
> (b) attacks upon the physical integrity of a person;
> (c) kidnapping or hostage taking;
> (d) causing extensive destruction to a Government or public facility, a transport system, an infrastructure facility, including an information system, a fixed platform located on the continental shelf, a public place or private property, likely to endanger human life or result in major economic loss;

12. Council Common Position of 27 December 2001 on the application of specific measures to combat terrorism (2001/931/CFSP).

(e) seizure of aircraft, ships or other means of public or goods transport;
(f) manufacture, possession, acquisition, transport, supply or use of weapons, explosives or of nuclear, biological or chemical weapons, as well as research into, and development of, biological and chemical weapons;
(g) release of dangerous substances, or causing fires, explosions or floods the effect of which is to endanger human life;
(h) interfering with or disrupting the supply of water, power or any other fundamental natural resource, the effect of which is to endanger human life;
(i) threatening to commit any of the acts listed under a) to (h);
(j) directing a terrorist group;
(k) participating in the activities of a terrorist group, including by supplying information or material resources, or by funding its activities in any way, with knowledge of the fact that such participation will contribute to the criminal activities of the group.

For the purposes of this paragraph, "terrorist group" shall mean a structured group of more than two persons, established over a period of time and acting in concert to commit terrorist acts. "Structured group" means a group that is not randomly formed for the immediate commission of a terrorist act and that does not need to have formally defined roles for its members, continuity of its membership or a developed structure.'

Following this common position the EU pursued the freezing of funds, other financial assets and economic resources of alleged terrorists. Further, the EU Council agreed and decided that it would pursue collaboration between the EU Member States and to provide the widest possible assistance in preventing and combating terrorist acts.

3.4 The auditor's role in EU Directives

Following Convention 198 of 1991 and 2001 respectively, the EU issues EU Directive 2001/97[13] in December 2001. The purpose of this directive is to

13. Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001, amending Council Directive 91/308/EEC on prevention of the use of the financial system for the purpose of money laundering – Commission Declaration.

protect the financial system of abuse from money laundering and terrorist financing activities. The spectrum of this directive has been broadened in such a way that its provisions also apply to professional activities of external auditors and tax consultants. The directive's scope widened to also include the money laundering of proceeds from severe punishable acts. A definition of what 'severe punishable acts' meant to be was not given yet. However, EU ministers agree that 'financing of terrorism' forms part of a 'severe punishable act'.

In 2003, FATF has given more detailed guidance regarding client identification, client verification, situations of increased money laundering risk as well as situation with a decreased money laundering risk. The revised 40 FATF Recommendations now form part of the EU legislation and accordingly of the legislation of EU Member States. Based on a revision of the FATF 40 Recommendations in 2003, which now also included the financing of terrorism into the definition of money laundering, the EU promulgated a new directive, EU Directive 2005/60[14] on 26 October 2005. In fact, the European ministers fully endorsed the 40 FATF Recommendations including the nine additional recommendations with regard to the combat against terrorist financing through including the spirit of the recommendations into a new European Directive.

In the latest EU Directive (2005/60), the role and responsibilities of the external auditor are described. According to Article 20 of the EU Directive 2005/60, Member States shall require that the institutions and persons covered by this directive, auditors included, pay special attention to any activity which they regard as particularly likely, by its nature, to be related to money laundering or terrorist financing and in particular complex or unusually large transactions and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose. However, based on Article 23 of the EU Directive 2005/60, the duty to report does not apply to external auditors with regard to information they receive from or obtain on one of their clients, in the course of ascertaining the legal position for their client or performing their task of defending or representing that client in, or concerning judicial proceedings, including advice on instituting or avoiding proceedings, whether such information is received or obtained before, dur-

14. Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing.

ing or after such proceedings. In this regard, it should be noted that in the Dutch environment, the external auditor usually does not represent the client in legal or judicial proceedings. This would impair the independence of the external auditor and it is in violation with the provisions of the Dutch regulation regarding auditor independence.[15]

15. More particularly, paragraph 2.3 of the Dutch guidelines for auditor independence 'Nadere Voorschriften inzake Onafhankelijkheid van de Openbaar Accountant (ex artikel B1-290.1 VGC)', Royal NIVRA, Amsterdam, January 2007.

4 Bank for International Settlements Regulations

4.1 General

The Bank for International Settlements (further: BIS)[1] is an international organisation which fosters international monetary and financial co-operation and serves as a bank for central banks. The BIS is head quartered in Basel, Switzerland and fullfils its mandate as:

- a forum to promote discussion and policy analysis among central banks and within the international financial community;
- a centre for economic and monetary research;
- a prime counterparty for central banks in their financial transactions;
- agent or trustee in connection with international financial operations.

The BIS has issued a number of highly authoritative papers which provide practical guidance to central banks and financial institutions. Many of the BIS papers pertain more or less directly to the establishment of sound corporate governance and the regulatory supervision thereof at banks. The issue of compliance and the integrity of financial markets are widely described in these papers as is the responsibility of various parties such as management, compliance officer, internal and external audit and the role of supervisors.

Within the BIS organisation the Basel Committee of Banking Supervision (further: BCBS) is located. According to the BIS website, the objective of the BCBS is '[to provide] a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and

1. *See* http://www.bis.org/about/index.htm.

supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision'.[2]

In the past years, the BCBS has issued a number of authoritative papers with regard to the corporate governance, compliance function and internal audit function of financial institutions. These are the most important papers:

- Framework for internal control systems in banking organisations, September 1998;
- Customer due diligence for banks, October 2001;
- Internal audit in banks and the supervisor's relationship with auditors: *A survey,* August 2002;
- Compliance and the compliance function of banks, April 2005;
- Core principles methodology, October 2005;
- Enhancing corporate governance for banking organisations, July 2005;
- Core principles methodology, *Consultative Document,* April 2006.

In the following paragraphs, reference will be made to the above-mentioned papers.

4.2 Audit in BCBS Papers

According to the BCBS, corporate governance of banks is of greater importance that in other business organisations because of the crucial role banks play as financial intermediaries and the degree of sensitivity of potential difficulties arising from ineffective corporate governance and of weaknesses in controls. It is the responsibility of management to establish proper corporate governance. From a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, which affects how banks:

- set corporate objectives (including generating economic returns to owners);
- run the day-to-day operations of the business;
- meet the obligation of accountability to the shareholders and take into account the interests of other recognised stakeholders;

2. *See* http://www.bis.org/bcbs/index.htm.

- align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and
- protect the interests of depositors.[3]

According to the BCBS, a competent and independent audit function is a vital part of the organisation's corporate governance. One of the important audit roles is identifying problems with a company's risk management and internal control systems and ensuring that the bank's financial statements fairly represent the financial position and performance of the company in all material respects. The BCBS also recommends that the board of directors meet with the external and internal auditor as well as with the head of compliance in the absence of management at least annually so as to strengthen and emphasise the independence of audit and compliance reporting to the board.[4] The BCBS recommends that banks establish an internal audit function.[5] In the same way, the BCBS recommends that banks establish an independent compliance function. Both functions should have direct reporting lines to the board.[6]

Both the compliance and the audit function can only exist and perform in a professional way when there is sufficient support from top management. For both functions, top management should be defined as the chief executive officer or chairman of the managing board. Only with reporting lines directly to the CEO or chairman of the managing board, both functions will obtain a sufficient status in the entire organisation. In its Principle 1 (BCBS, 2005-1, p. 9) the BCBS specifically recommend that it is the responsibility of the board to oversee the bank's management of compliance risk. The head of compliance should therefore have direct access to the board for presenting the compliance policy, the compliance plan and the compliance report on a regular basis.

The core function of compliance is to support managing compliance risk, which is defined as the risk of legal or regulatory sanctions, material financial loss, or loss of reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation

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3. BCBS, Enhancing corporate governance for banking organisations, July 2005, p. 4-5.
4. Ibid p. 13-14.
5. BCBS, Internal audit in banks and the supervisor's relationship with auditors: A survey, August 2002.
6. BCBS, Compliance and the compliance function in banks, April 2005.

standards, and codes of conduct applicable to its banking activities (together, *'compliance laws, rules and standards'*) (BCBS, 2005-1, p. 7). In this respect, the compliance function is responsible to establish an appropriate compliance infrastructure, which activates top management support. Line management is responsible for ensuring full adherence with the compliance infrastructure at all times. The compliance function itself should be subject to audit. This audit can be performed by the internal audit function within the bank, provided that the internal audit function has appropriate compliance expertise and is sufficiently independent from the compliance function. The purpose of this audit is to ascertain that the compliance infrastructure, as established by the compliance function, is consistent with applicable law and regulation, BCBS regulations included. Furthermore, audit should ascertain that compliance policies and procedures are adhered to by management. The audit report with regard to compliance should be forwarded directly to the board, whose role it is to oversee the compliance function.

The core task of internal audit is to audit the organisation's internal control systems comprising of operational controls, including ICT controls, and financial controls and to report on its findings to top management and the board of directors.

In the recent past, an internal control system had to be compliant with the Regulation on Organisation and Control (ROC),[7] which has been superseded since the enactment of the Law on Financial Supervision in 2007.

Analysing the ROC more in detail, it becomes apparent that the institution's system of internal controls must broadly comply with the COSO[8] model. This means that the main components of the COSO model are integrated in the ROC. In 2004, COSO revised the internal control integrated model and issued the so-called Enterprise Risk Management (ERM) framework.[9] The 1992 COSO components are also included in this ERM framework.

These ERM components are:

- Internal Environment;
- Objective Setting;
- Event Identification;
- Risk Assessment;
- Risk Response;

7. *See* http://www.dnb.nl/dnb/home/file/4201e_tcm47-146251.pdf.
8. COSO, Internal Control, Integrated Framework, New Jersey, 1992.
9. COSO, Enterprise Risk Management, Integrated Framework, New Jersey, 2004.

– Control Activities;
– Information & Communication;
– Monitoring.

After superseding the ROC with the enactment of the Law on Financial Supervision, the COSO model of internal control remains applicable and continues to be a widely acknowledged international standard for internal controls.

4.3 The auditor's role and responsibility pursuant to Basel II

According to Saidenberg and Schuermann,[10] there are basically two reasons for capital regulation of financial institutions. The first is the protection of consumers from better informed and opaque financial institutions. The second is the systemic risk to which banks are exposed. Financial institutions are exposed to systemic risk because of their role in the international payment system, their – sometimes highly – leveraged and fragile financial position. The fragility of the financial position has become clear and has surfaced dramatically in the recent period after September 2007 due to the so-called 'sub-prime crisis'. In the period following September 2007, amounts for loan and mortgage assets exceeding US$ 200 billion have been written off globally by financial institutions and some of them have arrived at the brink of bankruptcy, such as Northern Rock in England and Bear Stearns in the US. Basically, the capitalisation fragility of financial institutions materialises when these institutions are impaired in funding their activities, which is a direct result of loss of trust. The sub-prime crisis is a funding and mutual trust crisis among financial institutions in the first place rather than a crisis resulting from a valuation impairment of certain high risk assets.

In 1988, the BCBS set minimum capital standards for banks in the so-called Basel Capital Accord, or Basel I. Later in 2004, the BCBS issued the New Capital Accord, or Basel II, which is based on three pillars (BCBS, 2006-2).

Pillar 1 sets out the rules for minimum capital requirements for banks. The minimum capital requirements is a function of the institution's risk profile, predominantly determined by its risk weighted assets on the balance sheet.

10. Saidenberg, Marc, Schuermann, Till, *The New Basel Capital Accord and Questions for Research*, Wharton, Federal Reserve Bank of New York, 2003.

Pillar 2 is about the key principles of supervisory review, risk management guidance and supervisory transparency and accountability produced by the BCBS with respect to banking risks, including guidance relating to, among other things, the treatment of interest rate risk in the banking book, credit risk (stress testing, definition of default, residual risk, and credit concentration risk), operational risk, enhanced cross-border communication and cooperation, and securitisation.

The core rationale for Pillar 3 'Market Discipline' is to complement the provisions of Pillar 1 (minimum capital requirements) and Pillar 2 (principles for supervision) with disclosure rules allowing market participants to assess the information and hence the capital adequacy of the reporting financial institution.

A basic underlying principle in Basel II is that banks must have an internal procedure to assess capital adequacy based on the risk profile and exposure of its operations. Banks must have a strategy for maintaining adequate capital levels over time.

Internal and external auditors have a specific role and responsibility following the New Capital Accord or Basel II. While the role and responsibility of auditors is generally clear, Basel II is not always consistent regarding the specific or distinct responsibilities of internal versus external auditors. In some instances both audit functions are mentioned, whereas in other cases only external auditors are mentioned to have a certain responsibility.

Banks must maintain an internal audit function (BCBS, 2002) and must also appoint an external auditor to audit the financial statements and monthly statements to the regulators. It is the responsibility of both audit functions i.e. internal and external, to arrive at a smooth professional collaboration resulting in coverage of the entire audit spectrum. The audit spectrum can be defined as the comprehensive scope of operational, ICT and financial audit areas. Audit coverage should be such that there is a minimum of redundancy and overlap between the work of both audit functions while audit gaps in the spectrum should be avoided to a maximum extent. In this spectrum, the external auditor has the predominant professional responsibility for the financial audit, whereas the internal auditor has the same responsibility for the operational audit. With regard to the ICT audit, both audit functions have distinct professional responsibilities, which gives rise to the need for tight collaboration.

Following the underlying principle that the bank must make its own assessment of capital adequacy based on an internal assessment of risk exposure,

it is the responsibility of the audit function, i.e. internal and/or external audit to review this internal process of risk assessment and capital calculation. It is possible that the primary audit assessment be performed by the internal audit department, in which case the external auditor should review the internal auditor's work. While avoiding redundancy to a maximum extent, the external auditor should perform his own assessment so as to satisfy independency requirements and to avoid becoming too much dependent on the internal audit function.

To assess the risk profile and exposure, banks make use of risk validation models. The purpose of these models is to calculate the value at risk (or: VaR) for credit risk, market risk, interest rate risk and other risk types. It is the auditor's responsibility to validate the models by:
- internally validating the risk assessment process applied by the bank;
- ensuring that the formulae used to calculate prices of options and other complex derivative instruments are appropriate under the circumstances and that these formulae are applied consistently;
- ascertaining that the models used are adequate and consistent given the bank's risk and business profiles;
- ascertaining that the bank's internal back-testing[11] of the models used is adequate;
- ensuring that the data flows used in the models are adequate and reliable.

Finally, even though internal and external auditors (must) collaborate smoothly, both audit functions have distinct responsibilities that may also effect their roles in view of Basel II. The core responsibility of the external auditor is the audit of the financial statements and the monthly statements to the regulators. The responsibility of the external auditor following Basel II should be interpreted in this context also. Ultimately, the external auditor issues an audit opinion on the true and fair view of the financial statements, which includes an opinion whether or not international financial reporting standards have been applied correctly and consistently.

The responsibility of the internal auditor follows from the BCBS papers and the charter of the internal audit function applied by the bank. The focus of internal audit is on operational, financial and ICT controls.

11. Back-testing is the process where the outcome of mathematical models such as calculated 'value-at-risk' and 'loss-given-default' are verified with actual results in the past.

There are strict independence requirements for internal audit also. Since the introduction of the by-law on professional behaviour for auditors,[12] the internal auditor must be independent from anyone in the organisation who is responsible for an audit object except for the CEO or chairman of the managing board. As a result of this independence requirement, the internal auditor should not be involved in model building or the establishment of an enterprise risk management function. The internal auditor should restrict the professional involvement in making a professional assessment of the models and the risk management function and while doing so, make recommendations for improvement if so needed.

12. Royal NIVRA, Verordening Gedragscode, December 2006, Article B2-290.1.

5 Some Relevant Dutch Laws

5.1 Law on identification with services (further: WID)

The WID was enacted in 1993 and is aimed at identifying clients of financial institutions. The identification of clients is a direct result of the 'Know Your Customer' recommendation made by FATF and the European Directive 91/308 regarding the prevention of abuse of the financial system for money laundering.

Pursuant to the Governmental Execution Order of 24 February 2003,[1] certain groups or market parties are obliged to identify clients prior to providing professional services. Banks have the obligation to identify clients prior to engaging into a client relationship. The external auditor who is engaged in an audit, a review or a compilation of financial statements is also among the groups that have an obligation to identify clients.[2] This execution order is the result of the enactment in the Netherlands of the revised European Directive 2001/97 of 4 December 2001.

It is essential that the external auditor is not allowed to provide services, as described above, prior to identifying the client. In certain cases, particularly in the international practice, the identification of the client cannot take place in the Netherlands. It is possible that this identification be performed by a third party i.e. an external auditor of a member firm abroad.[3]

During 2007, preparations are ongoing to amend the WID and to combine this law with the Law on Disclosure of Unusual Transactions (*see* paragraph 5.2). The amendment of the 'WID' does have consequences for banks in the process of identification of clients. The identification process is strengthened and client due diligence procedures are needed in all cases of

1. Governmental Execution Order *(algemene maatregel van bestuur)* of 24 February 2003, *Governmental Gazette* 2003, 94.
2. Ibid Article 1 (e), Article 4 (h)2.
3. Explanatory memorandum *(nota van toelichting)*, paragraph 2.1.2, *Governmental Gazette* 2003, 94.

client acceptance. These procedures are called 'client acceptance procedures' or sometimes 'client acceptance and anti-money laundering' procedures.

The absence of proper KYC procedures at banks may result in unwanted multiple risk exposure. Banks may become overly exposed in the areas of counterparty risk, reputation risk, operational risk, legal risk and concentration risk (BCBS, 2001, p. 3-4). Pursuant to the BCBS banks are required 'to have in place adequate policies, practices and procedures that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, by criminal elements' (BCBS, 2001, p. 5).

Client acceptance procedures aimed at KYC or extended KYC should principally be risk based. Different risk levels can be distinguished i.e.:

- neutral risk;
- increased risk; and
- high risk.

Neutral risk generally applies to bank clients who require standard banking services only such as salary accounts, saving accounts and simple loan or mortgage accounts. The client acceptance procedure for neutral risk clients is basic and based on official identification documentation, copy of which must be kept by the bank.

Increased risk applies to clients who need additional banking services such as business accounts, foreign exchange or international payment services. In addition to identification documentation, also business charters, annual financial statements and background information for these clients is needed in order to comply with the KYC requirements. This information can be maintained and updated based on client calls and visits of which records have to be kept by the bank.

High risk applies to more complex business conglomerates who require advanced (international) banking services and who will normally use multiple (sometimes hundreds or even thousands) of bank accounts. There is one category of clients that is high risk by default i.e. so-called 'politically exposed persons'. These clients maintain political or governmental positions or had such a position within one year ago. According to the explanatory memorandum with the proposal to combine the WID and the Law on Disclosure of Unusual Transactions,[4] the expression 'politically exposed persons' is now also introduced in the Dutch law.

4. Explanatory Memorandum *(memorie van toelichting), Wet tot samenvoeging van de Wet identificatie bij dienstverlening en de Wet melding ongebruikelijke transacties (Wet ter voorkoming van witwassen en financieren van terrorisme (31238)*, see www.minfin.nl.

The client acceptance procedures for high risk clients are extended, which means that comprehensive documentation of these clients must be maintained and kept. Normally teams of client relationship bankers keep in touch with the client and keep this information updated based on regular client calls and visits. Extensive information must be available about the business purpose and rationale of the various banking products required by the client. The most difficult part of extended client due diligence is obtaining an understanding of the nature of the client's (international) business. This includes obtaining an understanding of the circle of businesses and persons with whom the bank's client maintains business relationships or in other words: trying to 'know the client's clients'.

Regarding compliance with the WID and the related client acceptance procedures, the internal auditor plays an important role. Internal audit has to validate the client acceptance procedures applied by the bank independently and report thereon to top management and the audit committee. This means that an audit of the bank's client acceptance procedures must be part of the annual internal audit programme.

Furthermore, the work performed by internal audit is an important source of information for regulatory authorities upon the execution of supervisory visits.

5.2 Law on disclosure of unusual transactions

Following the European Directive 91/308, the Dutch Law on Disclosure of Unusual Transactions (further: Wet MOT) was enacted at the end of 1993 and became effective in 1994 for financial institutions. The purpose of the Wet MOT is to take appropriate measures to combat money laundering and the financing of terrorism through a mandatory system of reporting of suspicious activities to a central reporting agency, i.e. the financial intelligence unit Netherlands (further: FIU-NL). The FIU-NL has its legal foundation in Title 2 of the Wet MOT. Its legal purpose is to gather, register and analyse data received as a result of unusual transaction reports and to support the pursuit of investigative and legal action in an attempt to curtail financial crime. The FIU-NL has the ability to share information with foreign intelligence units in order to support international legal pursuit of financial crime. Since 2003, a duty to report suspicious activities exists for certain

service providers. Based on a governmental execution order,[5] external auditors are among the service providers who have the duty to report suspicious activities to the FIU-NL. Compliance with the Wet MOT by external auditors is supervised by the Office of Financial Supervision (further: BFT).

An unusual transaction has to be reported to the FIU-NL if this activity is in line with so-called indicators. The lawmaker has issued an indicator list comprising objective and subjective indicators. For different parties that have the legal obligation to report unusual transactions under the Wet MOT, there are different indicator lists.[6] For the external auditor, the following objective indicators apply:

- Transactions that need to be reported to the police or to the department of justice also need to be reported to the FIU-NL.
- Cash transactions or transactions in bearer cheques of more than EUR 15,000 paid to or through the external auditor.

Next to the objective indicators there are so-called subjective indicators, which are very broadly defined. Both for banks and for professional service providers, among others the external auditor, the subjective indicator is 'any transaction that may give rise to a suspicion that the transactionis related to money laundering or terrorist financing'.

Anyone who provides a service on an occupational or commercial basis is obliged to disclose to the FIU-NL, without delay, any unusual transaction performed or planned in connection with that service (Wet MOT, Article 9, paragraph 1). Based on this article, a reportable condition exists when there is an intention ('planned') or an actual execution of an unusual transaction. The external auditor has a duty to report intended or executed unusual transactions that are intended or executed *in connection with* the professional services supplied by the auditor (*italics by author*). The connection requirement may give rise to interpretation difficulties. These difficulties may arise with regard to direct and indirect connection of the external auditor and with regard to the group auditor who is responsible for the audit of the consolidated financial statements of an international conglomerate. In this regard it is important to define the meaning of 'connection'. In general

5. Explanatory memorandum *(nota van toelichting)* Article 1 (e), Article 4 (h)2, *Governmental Gazette* 2003, 94.
6. *See* http://www.minfin.nl/nl/onderwerpen,financiele_markten/integriteit/wet_melding_-ongebruikelijke_transacties/indicatorenlijst.html#a7.

terms, an auditor may become ‘connected’ with an unusual transaction while executing a professional engagement for a client. The professional engagement is defined as the

– audit of the financial statements; or
– review of the financial statements; or
– compilation of the financial statements[7].

Direct connection

There is a direct connection with the transaction when an amount of EUR 15,000 or more in cash or bearer checks is paid directly or through the external auditor. In case an amount of EUR 15,000 or more is paid directly to or through the auditor, the ‘connection’ is clear and consequently the duty to file a report to the FIU-NL exists.

Indirect connection

It becomes more difficult when there is no direct payment of EUR 15,000 or more to or through the external auditor or if there are no traces (yet) of an unusual transaction in the accounting records, or when there is a plan or the intention of a transaction that might be unusual. In this case there is no duty to report as a result of the objective indicator, but there may be a duty to report pursuant to the subjective indicator.

Provided that the external auditor is informed about the planned transaction, he has to assess whether the transaction is unusual in the sense of the law and whether duty to report exists. The external auditor does not have a duty to actively search for such transactions nor does he have to produce conclusive evidence of the unusual character. The duty to report is solely the result of an assessment made by the external auditor.[8]

7. Governmental Execution Order (*algemene maatregel van bestuur*) of 24 February 2003, Article 2-1, sub f, *Governmental Gazette* 2003, 94.
8. *Richtsnoeren voor de interpretatie van de Wet identificatie bij dienstverlening en de Wet melding ongebruikelijke transacties voor belastingadviseurs en openbare accountants, Versie 2.3, november 2006.* It should be noted that the ‘Richtsnoeren’ are not legally binding and that the BFT may have a different i.e. broader interpretation in some case.

Responsibility of the independent group auditor in an audit of the consolidated financial statements of an international conglomerate

Another difficulty may arise in the case that the Dutch external auditor is the independent group auditor[9] of an international conglomerate. There may be instances that unusual transactions occur in a foreign group company within this conglomerate, i.e. in another jurisdiction than the Netherlands. These transactions may be unusual as a result of the Dutch objective or subjective indicators. The question is whether or not the independent group auditor has a duty to report these unusual transactions to the FIU-NL? In order to answer this question, there are two sub-questions to be answered i.e.:

- Is the external group auditor connected with the transaction?
- Does the external group auditor have knowledge of the transaction?

In the first place, it should be established that the independent group auditor is professionally connected with the unusual transaction, as required by Article 9, Wet MOT. Mostly, this is the case as the group auditor performs an audit of the consolidated financial statements in which the financial statements of the group company, forming part of the conglomerate are consolidated. If the transaction has taken place and traces thereof are reflected in the group company's accounting records, the independent group auditor is connected in the sense of Article 9, Wet MOT. If the unusual transaction is 'intended', but has not yet taken place, the connection in the sense of Article 9, Wet MOT is less clear and may not be adequate.

Secondly, it should be established whether the independent group auditor is informed about the unusual character of the transaction in the foreign group company. If the unusual character of the transaction is mentioned in a document of any kind such as:

- audit files or audit working papers of the local external auditor;
- interoffice memorandums to the group auditor;
- management letters;
- email correspondence;
- minutes of meetings or in any other kind of document;
- internal audit working papers;
- internal audit reports or memorandums such as
  - business understanding documents;

9. The 'independent group auditor' is the external auditor who is ultimately professionally responsible for the independent financial audit of the conglomerate's consolidated financial statements.

- o risk analysis documents;
- o interim or final audit reports

the independent group auditor is then aware or should have been aware of the transaction. Hence, he has to consider whether or not a report to the FIU-NL has to be made. If the independent group auditor considers that the transaction is unusual as a result of an objective indicator or if he considers that it is unusual as a result of the subjective indicator, a report to the FIU-NL should be made. This is solely the professional interpretation made by the independent group auditor.

A remaining question is whether the FIU-NL has jurisdiction pursuant to a report made by the Dutch independent group auditor of an unusual transaction that has taken place outside the Netherlands, but within the Dutch conglomerate. The independent group auditor does not need to make this consideration. It is a matter of international law and should be considered by the FIU-NL rather than by the auditor.

In line with auditing standard 250,[10] the external auditor has to perform a risk analysis of non-compliance with applicable law and regulations by the client and has to access the potential impact this may have on the financial statements. However, it should not be expected that an audit of the financial statements reveals all instances of non-compliance with applicable law and regulation.[11]

The question is what is exactly 'non-compliance with applicable law and regulations'? In the first place, this is a legal interpretation, which may surpass the core competence of the external auditor. Normally, a legal expert makes an assessment regarding 'non-compliance with applicable law and regulations'. The external auditor performs the audit of the financial statements. In this context he has to make an analysis of the risk of non-compliance with applicable law and regulations and accordingly has to assess the potential impact thereof on the financial statements. The practical consequence is that the external auditor asks questions regarding compliance with applicable law and regulations and that an audit of the compliance function will normally be included in the audit scope. However, it should be born in mind that an audit of the financial statements is not aimed at disclosing issues of non-compliance with applicable law and regulations. It

10. Royal NIVRA, International Standards on Auditing 250, Responsibilities Relating to Laws and Regulations in an Audit of Financial Statements.
11. Ibid paragraph 2.

may therefore occur that instances of non-compliance occur while the external auditor remains unaware.

According to Title 6, Article 18 and 19 of the Wet MOT, an unusual transaction report to the FIU-NL is a confidential report. The reason behind this confidentiality of unusual transaction reporting is the prevention of potential destruction of evidence by alleged perpetrators of money laundering or terrorist financing. This means that neither banks nor external auditors have the ability to communicate a report to the FIU-NL to their clients. Nor can external auditors communicate a report to the FIU-NL to a bank even if the bank is an audit client or to a succeeding auditor in a case of change of auditors. Hence, this may result in double or multiple reports made to the FIU-NL on the same unusual transaction. However, this is neither the concern of the external auditor nor of the financial institution which may also have reported the same unusual transaction. Double or multiple reports, if any, will be reflected in the records maintained by the FIU-NL.

In the case of alleged fraud, the nature of the alleged fraud may give rise to the suspicion of money laundering and as such give rise to the need to make a report to the FIU-NL. Based on auditing standard 240,[12] the external auditor is obliged to communicate indications of fraud with management and in certain cases with the audit committee. However, the external auditor cannot communicate the fact that the alleged fraud may have been the content of an unusual transaction report to the FIU-NL. When the auditor is asked whether or not there are Wet MOT implications, the answer can only be that the auditor cannot comment on or reply to this question. This is certainly not easy and may put a strain on the professional trust relationship between the auditor and the client. However, this is a situation 'the auditing profession has to live with'.[13]

5.3 Law on financial supervision

Since 1 January 2007, the Law on Financial Supervision (further: WFT) is applicable in the Netherlands. This law supersedes previous laws regulating the financial sector. The purpose of the WFT is to provide clarity regarding

12. Royal NIVRA, International Standards on Auditing 240, The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements.
13. Wallage, Prof. Dr. Philip RA, interviewed in: 'Vrije Beroepsbeoefenaren en het Witwassen van Misdaadgeld – Het Meldpunt van Ongebruikelijke Transacties', *Brochure Ministry of Justice,* p. 38.

the various norms and standards that apply to the financial sector. Whether the Dutch lawmaker has been successful in bringing clarity remains questionable. The WFT is a complex law and according to Vletter (2006) some people already called for a revision of this law at the time of enactment.

With regard to the supervision, the WFT makes a distinction between prudential supervision, which is the task of the Dutch Central Bank (further: DNB) and behavioural supervision, which is the task of the Authority of Financial Markets (further: AFM). In this respect, with the enactment of the WFT, the Netherlands applies a system of so-called functional supervision of the financial sector.

Pursuant to the WFT, the external auditor has a role in the supervision of financial companies. The main tasks and responsibilities for the external auditor are laid down in subchapter 3.3.10 '*Meldingsplichten van de accountant en de actuaris*'. Subchapter 3.3.10 applies to the roles and responsibilities of the external auditor vis-à-vis the DNB, in other words: the roles and responsibilities in the sense of prudential supervision. Similar roles and responsibilities exist vis-à-vis the AFM in the context of behavioural supervision pursuant to subchapter 4.2.4. '*Meldingsplichten*' of the law.

According to Article 3:88 of the WFT, the external auditor performing the audit of the financial statements of the financial company has the duty to report any instances of which he has knowledge indicating:

- a breach of the obligations laid down in Chapter 3 (Prudential Supervision) of the WFT;
- a potential discontinuation of the financial company.

According to Article 4:27 WFT, the external auditor performing the audit of the financial statements of the financial company has the duty to report any instances of which he has knowledge indicating a breach of the obligations laid down in Chapter 4 (Behavioural Supervision) of the WFT. A report made pursuant to Article 3:88 has to be made to DNB. A report made pursuant to Article 4:27 has to be made to the AFM. The external auditor informs the financial company when he intends to submit the requested information to the DNB or to the AFM. If the financial company so wishes, it can provide the regulator with the required information directly, in which case the external auditor must ascertain that the required information is indeed submitted. In the case that the external auditor submits information

to the regulator, he must send a copy of this information to the financial company.[14]

A distinction should be made between the duty to report following Article 3:88 of the WFT and the obligation to inform the DNB following the Execution Order '*Besluit prudentiële regels Wft*', dated 12 October 2006.[15] The flow of information from the auditor to the DNB is broader than the instances mentioned in Article 3:88 of the WFT. In order to inform the regulators, the external auditor has to submit the following documents:[16]

- the auditor's report to the managing board and the supervisory board;
- the management letter(s);
- other correspondence between the external auditor and the financial company which is directly connected with the auditor's opinion with the financial statements or regulatory statements;
- upon request of the regulator, the external auditor must provide subsequent information about the items mentioned before.

Analysing the external auditor's responsibility pursuant to this execution order, it is clear that only information has to be submitted to the regulator that is directly connected with the audit of the financial or regulatory statements. Information that is derived from other roles conducted by the external auditor is not required and does not fall into the scope of the duty to report.

Similar to the information flow to the DNB, there is an information flow to the AFM. With regard to informing the AFM, Execution Order '*Besluit gedragstoezicht financiële ondernemingen Wft*'[17] applies. The external auditor has to submit:[18]

- the auditor's report to the managing board and the supervisory board.
- the management letter(s).
- other correspondence between the external auditor and the financial company which is directly connected with the auditor's opinion with the financial statements or regulatory statements.

14. Ibid Article 137.
15. Execution Order of 12 October 2006, '*Besluit prudentiële regels Wft*'.
16. Ibid Article 136.
17. Execution Order, dated 12 October 2006, 'Besluit gedragstoezicht financiële ondernemingen Wft'.
18. Ibid Article 107.

Similar to the duty to report to DNB, the reporting can be done directly by the financial company, in which case, the external auditor has to ensure that appropriate reporting has indeed taken place.[19]

Analysing Article 3:88 and 4:27 WFT as well as the relevant articles in the Execution Orders, it is important to note that the obligation to make a report to DNB or to AFM is restricted to the external auditor performing the audit of the financial statements and regulatory statements. This means that the reporting duty does not apply to any other role the external auditor may have in the relationship with the client. In practice and strictly speaking, this means that an external auditor who conducts a special investigation or who acts as an advisor to a financial company and in connection with this assignment becomes aware of a breach of the provisions laid down in the WFT by the financial company and does not have to make a report to DNB or to the AFM.

In many instances though, it will be difficult to make a clear distinction in the different roles the external auditor may have. If the external auditor becomes aware of a breach of the WFT or of any other reportable condition, it is not always possible to clearly determine the role the external auditor has *at the moment* he becomes aware of it. It is therefore strongly recommended that the external auditor consults with the audit firm's professional practices department prior to making a report to the regulators in these cases. However, in the case that the external auditor is engaged to perform the audit of the financial and regulatory statements of the financial company, it is difficult to argue he has become aware of reportable conditions in another role than as auditor of the financial or regulatory statements. Regulators would expect that the lead external auditor (the 'engagement partner') is aware of all engagements of the audit firm with the financial company and as a result that the lead external auditor is also informed about the results of the other engagements. This is certainly the case in engagements with financial companies whose shares are listed in the United States. In this situation every engagement, regardless the financial magnitude or geographical location of the engagement, must be pre-approved by the company's audit committee.[20] Such pre-approval requests are made by the lead external auditor hence he is usually informed about all ongoing engagements. Consequently, the duty to report pursuant to the WFT should be interpreted broadly rather than narrowly.

19. Ibid Article 108.
20. Sarbanes Oxley Act 2002, Section 201 and Section 202.

According to Article 3:88, paragraph 5 and Article 4:27, paragraph 5, the regulators will enable the financial company to attend the meeting at which the external auditor will make the report. In practice, however, the external auditor should prefer to encourage the client to make the report directly to the regulators. In this situation, the role of the external auditor is to confirm the report made by the financial company. In fact, a report made by the external auditor *directly* to the regulators should be reserved for rare instances where management is unwilling to make the report or where the auditor has serious observations with regard to management's capabilities or integrity.

5.4 **Exonerations**

Based on Article 3:88, paragraph 6, the external auditor is exonerated from potential civil law suits that may arise pursuant to making a mandatory report to the DNB. This exoneration applies unless in all fairness and given the circumstances, the external auditor should not have reported to the regulators. A similar exoneration applies pursuant to Article 4:27, paragraph 6 for mandatory reports made to the AFM.

An exoneration clause is also included in Article 13, Wet MOT. Also in this article, the restriction is that the exoneration does not apply to cases where in all fairness and given the circumstances, the reporting institution/person (e.g. the external auditor) should not have reported to the FIU-NL.

These exonerations apply to civil law suits against the reporting institution/person (e.g. the external auditor) who made a report pursuant to the legal obligation as laid down in the law (WFT or Wet MOT). As such, companies suffering financial damage resulting from such a report cannot make a claim to the reporting institution/person (e.g. the external auditor).

6 Conclusions

In summary, the protection of the financial market against abuse is essential for the licence to operate that financial companies have. As stated in the introduction, the combat against financial crime is not just an external battle. Banks must establish proper organisations and good corporate governance. In this address, I have emphasised the consequences following European and Regulatory law and regulations for banks in general and for the audit function more in particular.

The first initiatives in European lawmaking regarding the combat against money laundering date back to the early 1980s. During the 1980s and 1990s, the 40 FATF Recommendations and the nine special FATF Recommendations against terrorist financing have been included in the European Directives. Based on these European Directives, the Dutch law has been adjusted accordingly. Further modifications to the Dutch law are still ongoing such as combining the WID with the Wet MOT.

The roles and responsibilities of auditors in the context of protecting financial market integrity is laid down in various laws and regulations. A distinction should be made between external and internal auditors. The Dutch law, in particular the WFT, the WID and the Wet MOT prescribe certain legal responsibilities for the external auditor, such as the duty to report specific instances of breaches of the law and potential insolvency of a financial company to regulatory authorities and the obligation to furnish the regulators with more broad information contained in formal reports and management letters.

Regarding the reporting duties for external auditors following the Wet MOT, I have drawn the conclusion that such duty may also exist when unusual transactions occur within an international conglomerate, but outside the Netherlands. The legal consequences of such a report to the FIU-NL is not for the external auditor to consider, but a consideration to be made by the FIU-NL.

Furthermore, as a result of the confidentiality clause in the Wet MOT, it is possible that the FIU-NL does receive multiple reports with regard to one single unusual transaction. This is the result of the fact that communication about a report made to the FIU-NL is confidential and that communication about such a report is prohibited.

The roles and responsibilities of the internal auditor are laid down in authoritative papers promulgated by the BCBS, which form the basis of the design of corporate governance structures of financial companies. In this structure, a distinct independent position is prescribed for internal audit with reporting lines to top management and the audit committee of the supervisory board. Similar positions are prescribed for the compliance and risk management functions in financial companies. The establishment of these three functions is no longer voluntary, but forms part of good corporate governance of financial companies.

Finally, I have emphasised the role of auditor from the perspective of lawmaking with a certain focus on anti-money laundering and terrorist financing. I want the emphasise again that this is only part of the entire battle field of financial market abuse. Financial companies must establish proper organisations including proper segregations of duties between front and back office ('Chinese Walls'), pre-employment screening of management and staff, the identification and screening of integrity sensitive positions, procedures for personal account dealing and the prevention of the use of privileged knowledge. This address did not elaborate on the aspects of internal organisation. This will be subject to further study and publications.

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