Senate Caucus on International Narcotics Control
March 2, 2022

“The $150 Billion Drug Market: A Dive into the Economics of Cartels”

Responses to Questions for the Record
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CHAIR WHITEHOUSE

1. In “Private Investment, Public Harm”, which you co-authored with Lakshmi Kumar, you document the national security and financial vulnerabilities posed by the lack of anti-money laundering requirements on investment advisers and investment companies. For example, your report details how Mexican drug cartels allegedly used hedge fund accounts to launder a million dollars per week. Your report calls on the Treasury Department to revisit its 2015 rule that would subject investment advisers to Bank Secrecy Act reporting and recordkeeping Requirements. **If the Treasury Department was to revisit its 2015 proposed rule, what, if any, updates should it make?**

The opaque, $11 trillion U.S. private investment sector is increasingly vulnerable to money laundering schemes by drug cartels given the rapid growth and inherent complexity of the market. Further, demand for new, innovative secrecy vehicles after the passage of the Corporate Transparency Act – which brings transparency to U.S. entity formation – will only continue to drive the criminal and corrupt to exploit the opacity of U.S. private investment.

As part of the U.S. Strategy on Countering Corruption, the Biden Administration pledged to reexamine the 2015 Financial Crimes Enforcement Network (FinCEN) draft rule to instate minimum reporting anti-money laundering reporting obligations on registered investment advisers. While the rule, as drafted in 2015, would be an important step forward in bringing the U.S. private investment sector under the purview of the Bank Secrecy Act, it falls short in a couple of key areas.

First, the 2015 rule only looks at “registered investment advisers,” or those advisers that are required to register with the Securities and Exchange Commission (SEC). This exempts a potentially wide range of investment advisers, including investment advisers that manage less

than $100 million in assets in most states, as well as investment advisers to venture capital funds, and investment advisers to private funds with less than $150 million in assets under management, among others. A new rule should:

1) Expand the types of investment advisers covered, to further include all advisers either working as foreign private advisers or working solely with private equity, hedge funds, venture capital firms, family offices, rural business investment companies, or any other type of private fund; and
2) Revoke a "temporary" exemption given twenty years ago to unregistered investment companies – including private equity and hedge funds – to AML reporting requirements under the Bank Secrecy Act framework.

On the latter point, the White House committed in its Strategy on Countering Corruption to consider "whether to cover [in prescribing minimum anti-money laundering standards and reporting,] private placement funds, including investments offered by hedge funds and private equity firms," demonstrating momentum toward that effort.

Second, the 2015 rule seems to only require private investment advisers to fulfill the minimum diligence and reporting requirements under the Bank Secrecy Act. The Treasury Department should be encouraged to seek a higher level of AML obligation to prevent further abuse of the private investment sector. In particular, the new "know your customer" requirements should mandate (1) the identification of the beneficial owners of legal entities that open accounts, including single transaction clients; (2) evaluating all account holders and beneficial owners for money laundering risk; (3) ongoing monitoring of all accounts, with enhanced scrutiny of those with higher risk profiles; and (4) the filing of Suspicious Activity Reports with FinCEN. The U.S. Strategy on Countering Corruption stops short of requiring this level of scrutiny, promising instead to impose "minimum standards for anti-money laundering programs and suspicious activity reporting requirements." In light of recent revelations, these reforms are not adequate.

Separately, Congress might consider revisiting an unintended loophole in the Corporate Transparency Act that omits certain "pooled investment" vehicles (like private equity and hedge funds) from reporting their true (i.e., beneficial) owners to law enforcement, and the SEC has the authority to support and buttress any FinCEN AML rules. For example, the SEC has the authority to require private investment funds to report, among other things, their beneficial owners to the SEC and the Financial Stability Oversight Council to further understand the systemic risks posed by illicit flows into this extremely large and growing sector of the U.S. economy.

2. The Pandora Papers brought to light that shell companies as Nathan Proctor, author of Anonymous Overdose, said "are essentially a getaway car for drug profits." When fully implemented, the Corporate Transparency Act (CTA) will help eliminate these opaque vehicles by collecting beneficial ownership information. On December 7, 2021, the Financial Crimes Enforcement Network (FinCEN) issued a Notice of Proposed Rulemaking for the CTA. **What recommendations would you make to FinCEN to strengthen its draft rules?**

Drug traffickers often use anonymous shell companies to launder the ill-gotten gains of their criminal enterprises. The Corporate Transparency Act, which effectively ends the abuse of anonymous U.S. shell companies, provides an important first step to cutting off pathways for cartels to launder their money.

FinCEN's first proposed rule on the Corporate Transparency Act, which defines the law's beneficial ownership reporting requirements, is a strong draft that hews closely to the statute as well as to congressional intent. We share Senator Whitehouse's assessment in his comment letter with Senator Wyden approving of the rule's coverage of legal entities, proposed timelines for reporting an entity's true owner, narrow list of exemptions to match the statute, and definition of beneficial owner that ensures "at least one" owner is reported for their ownership or substantial control stake. Taken together, these aspects of the proposed rule should reduce gaps in coverage and improve the completeness, accuracy, and usefulness of information collected for use by law enforcement agencies and financial institutions.

Yet the rule must be strengthened in a few key ways. First, we share the Senator's concerns regarding exemption 22, known as the "subsidiary exemption", in which an entity "owned or controlled" by an exempted entity may also qualify for an exemption from reporting their true owner. The proposed rule defines this as "controlled or wholly owned" by an exempted entity; instead, this should read "wholly controlled and wholly owned." Failure to tighten this exemption to entities "wholly owned and wholly controlled" by the exempt owner leaves the door open to abuse. For example, if an entity is minority (or even, majority) controlled by an exempted entity, it could – under the current language – qualify for the same exemption. Such an outcome is against the spirit of the law and may act to hide beneficial owners that would otherwise be disclosed under the law.

Second, FinCEN officials must make certain that "FinCEN identifier" provisions improve database efficiency and minimize reporting burdens, but do not diminish ownership transparency or create a secrecy mechanism enabling beneficial owners to hide their identities from reporting companies. FinCEN can improve the draft rule by doing the following:

1) Delete inappropriate passages in the preamble allowing FinCEN identifiers to be used by beneficial owners to hide their identities from reporting companies;
(2) Clarify that entities applying for a FinCEN identifier must disclose all of their direct and indirect beneficial owners in the application submitted to FinCEN;
(3) Require reporting companies to delineate the ownership chain linking each of their indirect beneficial owners to the reporting company, including by identifying all intermediate entities;
(4) Clarify the circumstances under which a reporting company may use FinCEN identifiers for intermediary entities to avoid incomplete or misleading disclosures; and
(5) Adding examples to the final rule to illustrate how FinCEN identifiers are supposed to work.

Finally, FinCEN must take steps to ensure that the beneficial ownership registry will deploy real-time and automated verification mechanisms to ensure that certain submitted data, including names, birth dates, addresses, and identification numbers, are consistent with other government-held records. These steps would strengthen the rule on beneficial ownership reporting requirements as proposed. In future rulemakings, we share Senator Whitehouse's views that access to the database for authorized users – including law enforcement and national security officials, financial institutions with customer consent, banking supervisors, foreign allies, and the Government Accountability Office – must be full, uncomplicated, and timely. Further, the customer due diligence rules applying to certain covered financial institutions under the Bank Secrecy Act should be revised to conform to the Corporate Transparency Act in a manner that is consistent with the intent of the Corporate Transparency Act and that does not result in any increased opacity in the U.S. financial system.

3. In your written testimony for the March 2nd hearing, you note that "gatekeepers to the U.S. financial system by and large have no requirement to 'know their customer' or fulfill any other anti-money laundering obligation. The United States is in the last 10 percent of countries that have not taken the step of requiring non-financial business professionals to conduct anti-money laundering due diligence and related reporting." **What gatekeeper professions need to be brought under the U.S. anti-money laundering regime?**

Drug trafficking organizations regularly utilize non-bank service providers to gain access to the U.S. financial system. The lack of money-laundering safeguards in the U.S. among non-bank service providers means that these industries can be exploited to wash the profits and reputations of criminal leaders.

The U.S. Strategy on Countering Corruption already recognized the "deficiencies" of current anti-money laundering safeguards among non-bank service providers, including "lawyers, accountants, trust and company service providers, incorporators, and others willing to be hired as registered agents or who act as nominees to open and move funds through bank accounts." In the strategy, the Administration committed to "consider additional authorities to cover key gatekeepers, working with the Congress as necessary to secure additional authorities."

Congress should work with the Administration to cover those "gatekeeper" or "enabler" professions that are positioned to understand the financial workings of their clients. These gatekeepers include those who provide financial, company, trust, and third-party payment services for their clients, including those who form, buy, or sell companies, manage money and other assets, are involved in the coordinating, executing or advising of pooling and investing capital, process payments, and act as trustees, among others. While certain industries are particularly well-positioned to play these roles – be that lawyers, accountants, or corporate or trust formation agents and trustees – a legislative approach could focus on the function played by that professional rather than on the profession itself. This would make it harder for criminals to identify a professional who isn't covered to perform that function for them.

Still, Congress should use its oversight role to make sure that FinCEN is fulfilling its end of the bargain to instate anti-money laundering due diligence and reporting obligations on professionals specializing in high-value asset classes – e.g., real estate professionals, antiquities dealers, and art dealers. FinCEN has already initiated rulemakings on real estate and antiquities, but has not yet published final rules on these sectors. Congress can engage with FinCEN in the process to ensure the final rules are robust and helpful to law enforcement. Likewise, FinCEN has not yet pursued a rulemaking instating obligations within the U.S. art market, which the Senate Permanent Select Committee on Intelligence has named the "largest, legal unregulated market in the United States." Congress should urge FinCEN, whether through its oversight or legislative duties, to pursue a rulemaking to bring the art sector under the purview of U.S. anti-money laundering law.

4. During the March 2nd hearing, you underscored the importance of better collaborating with financial intelligence units in other countries. The Egmont Group consists of 167 financial intelligence units that share information and expertise to combat money laundering worldwide. This Group has successfully targeted the financial networks of drug trafficking organizations across the globe. Notably, China, which has been designated as both a major source of precursor chemicals and a major money laundering jurisdiction pursuant to the Foreign Assistance Act of 1961, is not a member of this group. In its most recent International Narcotics Control Strategy Report, the U.S. State Department found that "China has not cooperated sufficiently on financial investigations and does not provide adequate responses to requests for financial investigation information." **In light of this and the importance of enhanced international cooperation, do you think the Egmont Group could serve as a neutral convener and as an entrée to future cooperation on narcotics-related financial investigation information between the U.S., China, and other partner nations?**

Though encouraging China to join the Egmont Group may not present direct risks to law enforcement investigations, it is unlikely to deliver the desired result of enhanced international cooperation.

China is already likely receiving much of its desired information whether through bilateral MOUs with Egmont countries, or indirectly via its ties to the financial intelligence unit (FIU) in Hong Kong as another Egmont participant. For instance, in 2015, China and the United States arranged their own bilateral memorandum of understanding (MOU) to exchange financial intelligence to address the fact that China was not a member of Egmont. It's unclear that the promise of improved intelligence would be enough to incentivize China to join the international body.

Yet, the information China does receive, it consumes one-sidedly and is not often inclined to reciprocate information with its partners. The 2021 U.S. State Department International Narcotics Control Strategy Report (Volume II) had this to say about Chinese intelligence sharing:

> The People's Republic of China (PRC) is a global hub for money laundering…PRC authorities continue to identify new money laundering methods, including use of virtual currency. However, PRC authorities rarely share this type of information nor take sufficient action to interdict or counter these methods.

While the promise of enhanced intelligence sharing with other Egmont countries could incentivize stronger law enforcement cooperation and reciprocity, it seems unlikely given China's track record in other international fora.

Opponents of China's inclusion in Egmont may also raise concerns that its participation could 1) confer reputational benefits without extracting stronger commitments from China to improve its own anti-money laundering framework, and 2) that the information garnered from the intelligence sharing could be used to target dissidents or human rights activists. These concerns have not stopped Egmont from bringing in other jurisdictions ripe with money laundering concerns (e.g., Macau) or with unsavory human rights records (e.g., Azerbaijan or Syria). Still, proponents should proceed with caution.

Congress may consider getting more information before proceeding with its recommendation. The Anti-Money Laundering Act of 2020 (AML Act) which passed as part of the FY2021 NDAA, requires FinCEN to write and publish a report analyzing money laundering risks affiliated with China. This committee could consider consulting the authors of that report, once compiled, on the best ways the U.S. could help improve cooperation in a way that adequately serves our mutual interest in combating international money laundering.

<u>CO-CHAIR GRASSLEY</u>

1. The average American may not understand how cartels and money laundering organizations affect them. But they've undoubtedly fueled our current drug crisis by creating and trafficking drugs, humans, and facilitating illicit activities. **Can you help explain how the actions of cartels and money laundering organizations impact our daily lives and their influence is a kitchen table issue?**

Drug cartels laundering money through the United States can certainly feel abstract to the average person, made real only through television shows or movies. Yet the harms perpetuated by these illicit financial flows undermine public health and safety, introduce risks to U.S. markets, and can undermine legitimate business interests.

Drug trafficking organizations – while obviously major drivers of public health harms related to the nationwide opioid crisis – also have less obvious but equally important impacts on public health and safety. For instance, the Miami Surfside Condo collapse that killed 98 people had its roots in the drug trade. Investigative reports show that cartels invested money into Miami real

estate in the 1980s as a way to launder money, but failed to construct or maintain the buildings in a way that complied with city codes, leading to the tragic death of civilians who did nothing wrong other than to trust the building's owners to provide for their safety.

Further, money laundering through opaque U.S. markets – whether by drug traffickers or other politically exposed, corrupt, or criminal persons may present systemic risk to investment markets. Allowing complete secrecy in access to swaths of the U.S. financial sector–like the $11 trillion private investment industry–emboldens and empowers bad actors and may undermine the rule of law in foreign jurisdictions–including where cartels call home. This alone may contribute to a destabilizing geopolitical landscape by entrenching corruption.

Relatedly, in response to Russia's illegal invasion of Ukraine, the United States has coordinated with its allies to levy extensive sanctions meant to isolate Russia's corrupt economy, including individual oligarchs and officials. A lack of comprehensive anti-money laundering obligations unquestionably contributed to entrenching Putin and his cronies' political power in Russia and abroad. With the global community imposing sanctions on particular countries, businesses, or individuals, the fallout from these sanctions may be entirely unpredictable when we have no true concept of where and how these corrupt actors have parked their money.

Finally, the laundering of illicit drug proceeds perpetuates additional harms that undermine legitimate businesses. Money laundering typologies, including those that rely on "front" businesses can make it much more difficult for legitimate businesses to compete with businesses that are not necessarily operating to be profitable. Legitimate businesses may also be put in a position where they do not understand their supply chain as a result of unknowingly engaging with front businesses. This presents risks to the operations of legitimate businesses.

2. Cartels are sophisticated business organizations. Since their product is illicit drugs, we must address drug supply and demand. But, to undermine cartels, we must also target their finances and ability to fund their illicit acts. **What do you think is an effective way to zero in on cartels' wallets to stop their businesses from growing?**

Targeting drug trafficking organizations where it hurts – their wallets – requires reforms both to law enforcement priorities and to the safeguards protecting the U.S. financial system to deny these organizations tools to launder their illegal profits.

First, resourcing and metrics of success within law enforcement organizations must change so that there are incentives to take on long-term, financial investigations that can cut off criminal organizations' financial networks. Often, law enforcement does not have the resources or the know-how to take on these long-term investigations. Further, often metrics like case counts are often more valued than the significance of an investigation to shut off the spigot for these cartels. Rethinking how we quantify law enforcement success could be helpful to take on cartels' profits.

One related, important action Congress can take is to authorize – as FACT's member Global Financial Integrity has put it – a "reimagining" of FinCEN's mission to include the creation of an academy to train state, local, and federal law enforcement on best financial investigative practices.

Second, there must be structural reforms to the U.S. anti-money laundering framework to deny drug trafficking organizations the financial secrecy tools to launder money. This includes encouraging the full implementation of the Corporate Transparency Act to end the abuse of anonymous U.S. shell entities, passing legislation to bring enabler professions under the Bank Secrecy Act, and bringing the private investment industry and real estate, art, antiquities, luxury goods (like yachts and planes), and digital currency markets within a comprehensive anti-money laundering framework that involves, at a minimum, risk-based customer due diligence and commensurate reporting requirements.

Third and finally, Congress must fully resource the Financial Crimes Enforcement Network and the Office of Terrorism and Financial Intelligence in the FY23 appropriations bill, to ensure that these rulemakings can move forward to deny drug traffickers the means to launder their money in the U.S. For example, in 2021, the President requested $191 million for FinCEN, and the omnibus budget only delivered $161 million, plus a supplemental amount in light of Russia's invasion of Ukraine. FinCEN's workload has only increased since the initial request for $191 million and FinCEN should be funded accordingly in 2023.

3. In your prepared testimony, you stated, "Congress should also note that there are certain trusts and other entities exempted from or otherwise not covered by the Corporate Transparency Act and subsequent draft rule that may still pose risks for narcotics trafficking and money laundering. Congress should examine these exemptions and consider if they warrant further legislative action."

> **1) What are examples of these trusts and other entities that may still pose risks for narcotics trafficking and money laundering?**
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> The Corporate Transparency Act requires LLCs, corporations, and "other similar entities" to declare their true, beneficial owner(s) to a directory housed at the Financial Crimes Enforcement Network (FinCEN). FinCEN's first draft rule implementing the Act, released December 2021, defines "other similar entities" as entities that form or register to do business in a state by filing a document with the state Secretary of State, or other similar office. While FinCEN proposes that this definition would include limited liability partnerships, limited liability limited partnerships, business trusts (a/k/a statutory trusts or Massachusetts trusts), and most limited partnerships – in addition to corporations and LLCs – it leaves out other entities not formed by filing with a Secretary of State or similar office, including certain trusts and general partnerships.
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> In recent decades, there has been a rapid growth of state laws authorizing the formation of U.S. trusts and other entities with hidden owners and the capacity to conduct a wide

range of activities within U.S. borders. States competing for investment and engaging in a "race to the bottom" on financial secrecy may likewise adapt their entity formation laws to evade certain disclosures under the CTA.

Recent revelations in the Pandora Papers have been illustrative, but not unexpected. In a South Dakota trust that would not currently be subject to the CTA, known drug money-launderer Jose "Pepe" Douer parked near $100 million in wealth that now maintains his ill-gotten fortune for his family. Pepe died, but U.S. law now protects his fortune, and absent investigative journalism, no regulatory agency in the U.S. would ever have been the wiser.

Congress should ensure strong implementation of the Corporate Transparency Act occurs pursuant to current rulemaking efforts, and legislate to close any gaps in the Corporate Transparency Act, such as by requiring beneficial ownership reporting for entities that do not necessarily file with States in connection with forming. Measures by Congress should anticipate how to provide for the greatest transparency in disclosures amid potential adaptation by state actors.

2) If Congress considers enlarging the scope of the Corporate Transparency Act to create reporting requirements for a greater number of entities, what distinctions can be made between at-risk entities and those that have to little or nothing to do with money laundering, so as to not place administrative burdens on individuals who have nothing to do with laundering money?

The Corporate Transparency Act already includes 23 risk-based exemptions meant to avoid unnecessarily duplicative reporting requirements. Under the Act, FinCEN is to review the effectiveness of these exemptions, including as to whether these exemptions may be inappropriate or whether further exemptions may be merited. Under proposed rules, FinCEN wisely followed Congressional intent in not initially adding any new exemptions, opting to first carry out the plain reading of the statute so that any exemption-related decisions can be made upon further study.

Speed limits apply to everybody to keep the roads safe and working effectively. Only speeders get tickets. For the vast majority of small businesses and other beneficial owners of legal entities, including trusts, reporting under the Corporate Transparency Act will be straightforward and even initially light administrative burdens–less than $50–are expected to nearly dissipate over time. For those very limited instances where actors have knowingly and purposefully engaged in sophisticated entity planning involving complicated legal and ownership structures, costs associated with this planning should incorporate consideration of following the rules that everybody else plays by to keep our markets safe and effective.

4. I recently introduced legislation that would criminalize the transportation of money across a U.S. border for the purpose of evading U.S. taxes (S. 3697, Combating Money Laundering,

Terrorist Financing, and Counterfeiting Act of 2022), alongside the current crime of engaging in a financial transaction involving an unlawful activity for the purpose of evading U.S. taxes.

1) **How much money goes unreported to the IRS every year because of cross-border transportation of money for the purpose of evading the payment of federal taxes?**

While billions of dollars move across U.S. borders each year, it is hard to estimate how much of this money is transported for the "purpose of evading the payment of federal taxes." IRS data on the "tax gap," is not provided in real time, and the last estimates of these numbers are from 2011 to 2013. Notably, this is before reporting obligations under the Foreign Account Tax Compliance Act (or FATCA) began to apply in 2015. In a nutshell, FATCA requires foreign financial institutions to conduct diligence and share data on financial accounts held directly or indirectly by U.S. taxpayers with the IRS. Under FATCA, foreign financial institutions face steep 30% withholding if they fail to comply with their diligence requirements, reporting requirements, or "pass-through" withholding requirements. Information is shared with the IRS directly or through host governments under FATCA bilateral agreements. Under FATCA, the U.S. isn't exactly giving reciprocal information to our allies. In fact, the U.S. is not really providing much information at all. This is in contrast to many of our allies who more automatically share relevant information.

This is relevant because, since the inception of FATCA, one noticeable effect has been an increase in the opening of U.S. financial accounts–indicating that the U.S. is now itself a powerful secrecy jurisdiction, potentially facilitating tax evasion committed against other nations. In other words, the U.S. is a destination to park and grow laundered money (not just earn dirty cash). Combined with certain federal tax laws that may be favorable to both foreign and domestic wealthy individuals, there are reasons to keep money in the U.S. to avoid paying taxes throughout the world. It is also relevant because FATCA and other automatic exchange of information regimes both myopically focus on financial accounts, and not necessarily other high-risk tax evasion and money laundering vehicles, such as anonymous shell entities, real estate, art, antiquities and luxury goods.

Greater financial transparency and international cooperation is needed to better understand and address the risks of global money laundering and tax evasion. This Congress can support these efforts by helping to advance many of the reforms previously identified, and ensuring that information gathered in the U.S. is appropriately accessible to our allies or made publicly available, taking into consideration any valid privacy concerns.

The language provided in the Combatting Money Laundering, Terrorist Financing, and Counterfeiting Act may provide a helpful tool to the IRS to consider new ways of prosecuting crimes, including because the proposed legislation would apply to all means of money transfers, including wire or electronic funds transfer. The bill's authors may consider commissioning a study to provide more detailed information on the scale of this risk and ways it can be combated. Congress should further consider better resourcing the IRS Criminal Investigations office to help them investigate and collect aggregated data on this risk.

2) What are the most popular means of transporting money across the U.S. border for the purpose of evading the payment of federal taxes?

It is most likely that tax evaders use more formal methods to move money for the purposes of tax evasion, whether that be moving money through anonymous entities, real estate, or through private investment vehicles.

As discussed above, FATCA has provided a powerful tool in detecting offshore financial accounts and financial asset holdings of U.S. persons. Nonetheless, the scope of FATCA would be limited when combined with vast and complex networks of shell entities that might result in an otherwise non-U.S. citizen or resident taxpayer transporting money across the U.S. border for the purpose of evading payment of federal taxes or other criminal purposes and parking those assets in financial accounts. It also would also not necessarily cover the transport of money across borders and invested in non-financial accounts or assets.

As a result, Congress should work to implement the structural reforms suggested in these responses with respect to anonymous legal entities, and improving transparency in real estate, private investment, art, luxury goods, antiquities, and digital assets markets, including to ensure that these reforms are rooted in international cooperation. The proper funding of agencies responsible for standing up and enforcing these reforms, such as FinCEN and the IRS, is also critical.