2004

Report of the

Auditor General of Canada

to the House of Commons

NOVEMBER

Chapter 2

Implementation of the National Initiative to Combat Money Laundering

Office of the Auditor General of Canada

The November 2004 Report of the Auditor General of Canada comprises eight chapters, a Message from the Auditor General, and Main Points. The main table of contents is found at the end of this publication.

The Report is available on our Web site at www.oag-bvg.gc.ca.

For copies of the Report or other Office of the Auditor General publications, contact

Office of the Auditor General of Canada
240 Sparks Street, Stop 10-1
Ottawa, Ontario
K1A 0G6

Telephone: (613) 952-0213, ext. 5000, or 1-888-761-5953
Fax: (613) 954-0696
E-mail: distribution@oag-bvg.gc.ca

Ce document est également disponible en français.

Cat. No. FA1-2004/2-9E
ISBN 0-662-38462-8

Chapter

2

Implementation of the National Initiative to Combat Money Laundering

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

Table of Contents

Implementation of the National Initiative to Combat Money Laundering

Main Points

2.1 To strengthen its anti-money-laundering strategy, in 2000 Canada introduced the National Initiative to Combat Money Laundering, making it mandatory to report certain financial transactions to the new Financial Transactions and Reports Analysis Centre, or FINTRAC. The mandate of FINTRAC was to analyze these transaction reports and disclose information to police and other authorities to facilitate the investigation and prosecution of money laundering. After September 11, 2001, FINTRAC's mandate was broadened to also apply to the financing of terrorist activities. Canada now has a comprehensive strategy against money laundering and terrorist financing that is generally consistent with international standards. However, a number of factors impede the strategy's performance.

2.2 Legislation limits the information FINTRAC may disclose on suspicious transactions to so-called "tombstone" data: account numbers; names of the account holders; and places, dates, and values of transactions that have occurred. When a disclosure is related to an ongoing investigation, these data can be useful in corroborating findings or providing new leads. Otherwise, law enforcement and security agencies normally find that the information FINTRAC discloses is too limited to warrant action, given their existing caseloads and scarce resources. In short, as the system now works, FINTRAC disclosures can contribute to existing investigations but rarely generate new ones.

2.3 Effective efforts against money-laundering and terrorist-financing activities begin where these activities take place—with the financial institutions and others that handle the illicit funds. FINTRAC has an extensive outreach program to help the parties who are required to report understand their obligations. However, it gives them little feedback on their reports and on trends in money laundering and terrorist financing, feedback that could help them identify suspect transactions and produce better reports. Moreover, policies and procedures to monitor and ensure their compliance with reporting requirements have still not been implemented fully.

2.4 The Initiative involves a partnership among several federal organizations, law enforcement and security agencies, and industry regulators. All of these partners need to work together closely if resources are to be used effectively to detect and deter money-laundering and terrorist-financing activities. We found that while the partners interact regularly, co-operation among them could be improved.

2.5 One area where improved co-operation would help is the development of effective accountability mechanisms for the Initiative. FINTRAC collects and analyzes huge quantities of reports and other information and provides financial intelligence to law enforcement agencies and other authorities. It depends on their feedback to know how they use its disclosures and to what benefit. To date, however, not all recipients track their use of the information disclosed to them by FINTRAC. Without a comprehensive system for monitoring the use of its disclosures, it is impossible for FINTRAC to assess the value of the intelligence it provides and how it can be made better. It is equally impossible to assess the Initiative's performance overall and its impact on money-laundering and terrorist-financing activities in Canada.

2.6 We identified a number of government actions needed to make the Initiative more effective:

- Broaden the kinds of information that FINTRAC may disclose, within limits that respect the privacy rights of Canadians.
- Implement a management framework to provide direction and to strengthen the co-ordination of efforts within the federal government and with stakeholders at other levels of government and in the private sector.
- Establish accountability structures to ensure that the information needed for measuring the Initiative's performance is collected and that results are reported to Parliament regularly.

2.7 Legislation calls for parliamentary review of the Initiative by 5 July 2005. The parliamentary committee conducting that review may wish to look at these issues and at whether lawyers are still exempt from the anti-money-laundering legislation, as they have been since March 2003 following successful legal challenges.

The government has responded. FINTRAC, the Department of Finance Canada, and the Canada Revenue Agency are in general agreement with our recommendations. Their respective responses are included in full throughout the chapter.

Introduction

2.8 During the 1990s, the Paris-based Financial Action Task Force on Money Laundering, the international standard-setting body for efforts against money laundering, criticized Canada's anti-money-laundering strategy. Specifically, it criticized Canada for relying on the voluntary reporting of suspicious transactions and for lacking a central financial intelligence unit to receive, analyze, and disclose information related to money laundering.

2.9 The National Initiative to Combat Money Laundering, introduced in 2000, was designed in part to respond to these criticisms. Legislation adopted that year, the *Proceeds of Crime (Money Laundering) Act*, created a system for the mandatory reporting of suspicious financial transactions, cross-border transfers of large amounts of currency, and certain prescribed transactions. (Exhibit 2.1 indicates the types of parties and information to which the reporting requirements apply.) The legislation also established an agency, the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC), to collect and analyze these financial transaction reports and disclose pertinent information to the police and other authorities in order to help them investigate and prosecute money laundering.

Exhibit 2.1 Canada's anti-money-laundering reporting regime

Who must report

- Deposit-taking institutions
- Life insurance companies, brokers, or agents
- Securities dealers, portfolio managers, and investment counsellors
- Money services businesses
- Foreign exchange dealers
- Accountants and real estate agents, when carrying out certain activities for their clients
- Casinos
- Individuals or entities transferring large amounts of currency or monetary instruments into or out of Canada

What they must report

- Suspicious transactions on money laundering or terrorist financing
- Possession or control of terrorist-owned property
- International electronic fund transfers of $10,000 or more
- Cash transactions of $10,000 or more
- Cross-border currency transfers of $10,000 or more
- Customs seizure reports

Source: FINTRAC

2.10 After the terrorist attacks of September 11, 2001, Parliament broadened the scope of the anti-money-laundering legislation to also apply to the financing of terrorist activities. The *Proceeds of Crime (Money Laundering) Act* became the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*. The new act expanded reporting requirements to include the reporting of suspected terrorist-financing activities, and broadened FINTRAC's mandate to the detection, deterrence, and prevention of terrorist financing as well as money laundering.

2.11 Several government departments and agencies besides FINTRAC are directly involved in implementing the government's anti-money-laundering Initiative:

- The Department of Finance Canada is responsible for evaluating the Initiative, developing policies, and co-ordinating Canada's participation in international efforts against money laundering and terrorist financing.
- The Canada Border Services Agency administers the requirements for reporting cross-border transfers of currency or other monetary instruments, such as travellers' cheques, stocks, and bonds.
- The RCMP, the Canadian Security Intelligence Service (CSIS), and the Canada Revenue Agency receive and act upon information disclosures from FINTRAC.
- The Department of Justice Canada prosecutes money-laundering and terrorist-financing offences.
- Public Safety and Emergency Preparedness Canada has a leadership role under the National Agenda to Combat Organized Crime, which identifies money laundering as a national priority; a role in the accountability of other partners in the Initiative (namely, the Canada Border Services Agency, CSIS, and the RCMP); and a role in co-ordinating the development of policies to counter terrorist financing.

2.12 Exhibit 2.2 shows the resources allotted to the various partners for Initiative activities over the past four years; at the end of March 2004 they had spent a total of $140.1 million. FINTRAC received an additional $34.2 million over this period for its expanded mandate to detect and deter terrorist financing. Currently, the ongoing administrative costs of the Initiative and of FINTRAC's terrorist financing mandate total roughly $45 million a year. Reporting entities also spend considerable sums on compliance.

Focus of the audit

2.13 The Auditor General's April 2003 Report, Chapter 3, Canada's Strategy to Combat Money Laundering, set out the background to the government's anti-money-laundering strategy and the challenges it had to meet to be effective. This chapter reports on the results of changes to that strategy introduced in 2000 with the National Initiative to Combat Money Laundering.

2.14 The objective of the audit was to determine whether the management framework for implementing the Initiative

- is designed appropriately to promote the detection and deterrence of money laundering and terrorist financing, and
- provides accountability to Parliament for results achieved.

2.15 As FINTRAC and the new reporting requirements were the key elements in the Initiative, our audit focussed primarily on FINTRAC's operations. We also examined the anti-money-laundering activities of other partners in the Initiative, and especially their relationship to FINTRAC, which is key to how well the Initiative works and what it can achieve.

2.16 Legislation calls for a parliamentary committee to review the Initiative by 5 July 2005. We believe that the issues raised in our audit will be of interest to that committee and that it may find them useful in its review.

2.17 Further details on our audit objectives, scope, approach, and criteria are presented in **About the Audit** at the end of the chapter.

Exhibit 2.2 Spending on the National Initiative to Combat Money Laundering ($ millions)

Department	2000-01	2001-02	2002-03	2003-04	Total
FINTRAC[1]	18.0	25.5	26.3	22.2	92.0
Canada Revenue Agency and Canada Border Services Agency	5.3	6.0	6.0	6.0	23.3
RCMP	2.6	4.9	4.9	4.9	17.3
Justice Canada	0.6	1.2	1.2	1.2	4.2
Citizenship and Immigration Canada[2]	0.0	0.7	0.7	0.7	2.1
Finance Canada	0.3	0.3	0.3	0.3	1.2
Total	**26.8**	**38.6**	**39.4**	**35.3**	**140.1**

[1] Also received $10 million in 2001-02, $14.7 million in 2002-03, and $9.5 million in 2003-04 for its expanded mandate to detect and deter terrorist financing.

[2] Activities funded under the Initiative were integrated into the Canada Border Services Agency with the reorganization of government departments (December 2003).

Source: Finance Canada and FINTRAC

Observations and Recommendations

Institutional framework

Canada has a comprehensive anti-money-laundering system that is generally consistent with international standards

2.18 With the introduction of the Initiative, Canada now has in place most of the elements that the Financial Action Task Force on Money Laundering has recommended for an effective anti-money-laundering system. Canadian law makes money laundering a crime, based on a wide range of underlying offences. In addition, Canada has reporting requirements with broad application, and a financial intelligence unit with important advantages over counterparts in other countries:

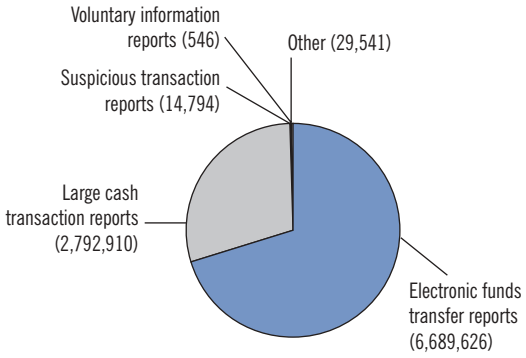
- A broad range of transactions must be reported to FINTRAC, including international electronic funds transfers in addition to large cash and suspicious transactions. Few other financial intelligence units receive reports on electronic funds transfers.
- Electronic reporting is required where it is possible; more than 99 percent of reports received by FINTRAC are filed electronically.
- In staff and resources, FINTRAC is among the largest financial intelligence units in the world.

2.19 At the same time, FINTRAC's operations and its capacity to provide financial intelligence to law enforcement are limited by a strict legislative framework designed to protect the privacy of the information FINTRAC receives. A key feature of that framework is FINTRAC's status as an independent agency that operates at arm's length from law enforcement. In addition, the conditions under which FINTRAC may disclose information and the information that it may disclose are set out specifically in legislation. These safeguards are unusual: most other countries allow much closer links and easier flow of information between their financial intelligence units and law enforcement.

2.20 In the four years since it was created, FINTRAC has invested heavily in computer technology and employee training to meet its objective of producing high-quality financial intelligence. It has devoted considerable effort to building relationships and developing policies to support the government's strategy against money laundering and terrorist financing. In this relatively short period, FINTRAC has established itself as a key player in that strategy, though it does not yet have all capabilities fully in place.

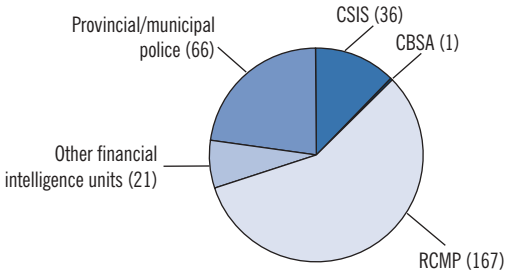
2.21 FINTRAC now receives some 10 million transaction reports a year (Exhibit 2.3). It analyzes these reports, together with other information it may collect, and it discloses designated information when it has "reasonable grounds" to suspect that the information may be relevant to the investigation or prosecution of money laundering or terrorist financing. In 2003–04, it made 197 disclosures to law enforcement and other agencies, up from 103 the year before. About one quarter of its disclosures were related to suspected terrorist financing and the rest to suspected money laundering. Exhibit 2.4 shows the distribution of FINTRAC disclosures by recipient agency.

Exhibit 2.3 FINTRAC received 9.5 million transaction reports in 2003–04



Source: FINTRAC

Exhibit 2.4 The distribution of FINTRAC disclosures in 2003–04, by agency



The total was 197 disclosures, but many disclosures were provided to more than one agency.

Source: FINTRAC

2.22 The impact of these disclosures is hard to assess adequately, owing in part to incomplete follow-up on how they are used. Officials from law enforcement and security agencies told us that FINTRAC disclosures contributed new intelligence to ongoing investigations but rarely led to new investigations. Investigations into money laundering and terrorist financing can be complex and lengthy. At the time of our audit, no prosecutions had been launched yet as a result of FINTRAC disclosures.

Success hinges on co-operation among many partners

2.23 The success of the Initiative depends on co-operation among not only the several federal departments and agencies involved as partners but also provincial and municipal law enforcement agencies and regulatory authorities, the financial sector, and others who are required to report. All of these partners and stakeholders need to work together closely if resources are to be used effectively to detect and deter money laundering and terrorist financing.

2.24 Federal partners in the Initiative interact regularly with each other and with external stakeholders. FINTRAC, in particular, has an ambitious outreach program and consults extensively with law enforcement agencies and reporting entities to explain what it does and to obtain feedback on its disclosures. The federal partners interact primarily through an interdepartmental working group led by Finance Canada. The group meets regularly and, although no minutes are kept, participants we interviewed said that it provides an effective means of discussing common issues. Interdepartmental meetings of officials at the assistant deputy minister level also take place from time to time and provide another forum for discussing Initiative issues.

2.25 Nevertheless, at the operational level we found signs of friction, such as the following:

- Despite the significant outreach efforts by FINTRAC over the past three years, police forces still are sometimes reluctant to share information with it and do not give much weight to unsolicited disclosures by FINTRAC.
- Connectivity problems between the information technology systems of FINTRAC and the Canada Border Services Agency have led to a large backlog of unprocessed reports on cross-border currency transfers.
- FINTRAC and the Canada Revenue Agency have yet to agree on criteria for identifying money-laundering transactions that could also be related to tax evasion.
- Some reporting entities told us that regulatory requirements are often announced or imposed on them without adequate appreciation of the difficulties and costs of compliance.

2.26 In an initiative with so many players, relationship problems are not surprising. Moreover, the anti-money laundering initiative is relatively new, and many of these problems could reflect inevitable growing pains. It takes time to establish effective networks for co-operation and to build the trust on which co-operation depends.

2.27 We believe that to support that process, more effective mechanisms and leadership are needed for co-ordinating efforts both within the federal government and among all stakeholders. At the federal level, the interdepartmental working group chaired by Finance Canada lacks the scope and mandate for effective support of a co-ordinated campaign against money laundering and terrorist financing. The meetings of officials at the assistant deputy minister level lack effective procedures for resolving interdepartmental disputes and ensuring accountability for results. We found, as we had in our audit of the anti-terrorism measures of 2001, that the government did not have a management framework to direct complementary actions in separate agencies.

2.28 The Initiative would also benefit from mechanisms that would bring in provincial and private sector stakeholders. Faced with a similar challenge, the United States and the United Kingdom have established anti-money-

laundering advisory committees with representatives of law enforcement, government, and industry. These committees meet regularly to consider emerging issues and develop approaches to dealing with them. They have proved useful in those countries, and such committees could help here as well.

2.29 **Recommendation.** The government should establish an effective management framework to provide direction and co-ordinate anti-money-laundering efforts at the federal level. It should also consider establishing an anti-money-laundering advisory committee with representatives of government, industry, and law enforcement to regularly discuss issues of common interest and develop approaches for dealing with emerging issues.

Finance Canada's response. As noted in the chapter, the Department of Finance chairs the current interdepartmental group at the assistant deputy minister level and its working-level extension. While these forums have been successful in co-ordinating initiative-wide efforts, reporting the results of these efforts, and discussing and resolving common issues, the Department of Finance will examine the roles of these interdepartmental groups and make any improvements or changes as required.

As well, the Department of Finance will review international best practices (including the UK and U.S. models) in considering the merits of establishing a formal advisory committee for the overall Initiative with broad representation from government, industry, and law enforcement.

Exemption of lawyers leaves a gap in coverage

2.30 Initial anti-money-laundering regulations included lawyers and legal firms among the entities required to report suspicious financial transactions. But legal service providers were exempted from the regulations in March 2003, following successful court challenges by lawyers on the grounds that reporting requirements violated lawyer-client privilege. This exemption is widely regarded as a serious gap in the coverage of the anti-money-laundering legislation. It means that individuals can now do banking through a lawyer without having their identity revealed, bypassing a key component of the anti-money-laundering system.

2.31 In a 2001 report on money-laundering trends, the Financial Action Task Force on Money Laundering (FATF) drew attention to the growing use of channels outside the financial sector to launder funds. It noted specifically that "lawyers, notaries, accountants and other professionals offering financial advice have become the common elements to complex money laundering schemes. This trend is mentioned by almost all FATF members." In response to these trends, the Task Force revised its "Forty Recommendations" in June 2003 to broaden the range of reporting entities covered, including notably lawyers, notaries, and other independent legal professionals.

2.32 The Task Force's recommendations are widely accepted as the international standard in national anti-money-laundering measures. The removal of lawyers from the reporting requirements of the legislation in Canada means that our anti-money-laundering system does not fully meet

international standards, yet meeting them was one of the objectives of the National Initiative to Combat Money Laundering.

2.33 Over the past 15 months, Finance Canada and Canadian law societies have been discussing options for bringing the legal profession back within the coverage of the legislation's reporting requirements without compromising lawyer-client privilege.

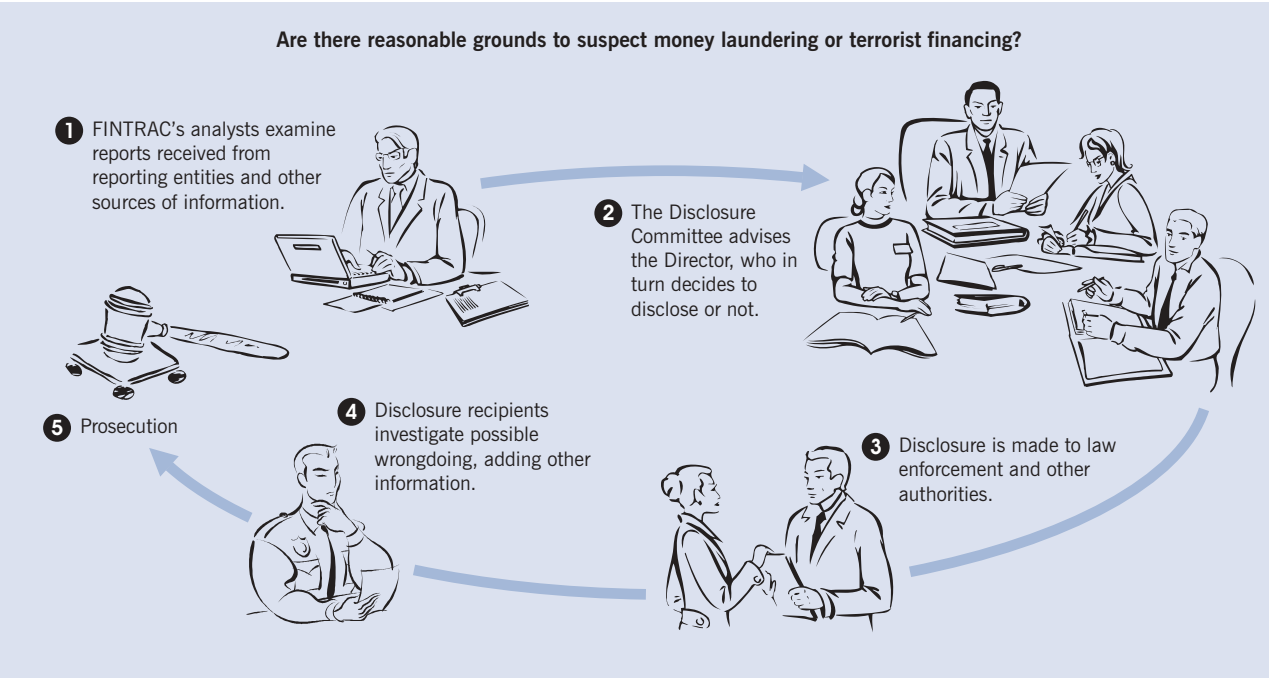
Disclosure of financial intelligence

No written criteria are used in deciding which cases to disclose

2.34 FINTRAC analysts review reports the agency receives, looking for links to money laundering or terrorist financing. They search FINTRAC's database for information linking a report to a broader pattern of financial transactions, and they match this information with information from other sources, including law enforcement and commercial databases and open-source electronic and print media. When the analysis reveals "reasonable grounds to suspect" that a transaction is related to money laundering or terrorist financing, the analyst recommends to FINTRAC's Disclosure Committee that a disclosure be made. The Committee, in turn, advises the Director, who makes the final decision (Exhibit 2.5).

2.35 Analysts use a wide variety of indicators from a number of sources to determine whether a transaction is related to money laundering or terrorist financing. These include indicators and typologies issued by the Financial Action Task Force on Money Laundering, as well as anti-money-laundering guidelines issued by a number of financial intelligence units to their reporting

Exhibit 2.5 How FINTRAC reports contribute intelligence for investigation and prosecution



entities. But FINTRAC has no set of written criteria to guide its analysts in determining when a threshold for disclosure has been met or to help the Disclosure Committee and the Director decide whether to disclose a case.

2.36 While it will always take a certain level of judgment to decide what constitutes "reasonable grounds" for suspicion, an explicit framework would help produce consistent decisions among analysts and over time. If developed with the assistance of law enforcement and security agencies and shared with them, a framework would also help improve their understanding of FINTRAC's disclosure threshold and increase their confidence in the value of the disclosures they receive from FINTRAC.

2.37 **Recommendation.** In co-operation with law enforcement and security agencies, FINTRAC should establish a set of written criteria to guide its analysts and its Disclosure Committee in determining which transactions to disclose.

FINTRAC's response. FINTRAC continually seeks to refine and improve the tools it uses for its analytical function. A reference guide of indicators was developed with the assistance of work done by the Financial Action Task Force and the Egmont Group of financial intelligence units. These internationally recognized indicators have been developed with input from law enforcement. In addition, FINTRAC, with law enforcement and security agency representatives, will review the current guide of indicators to ensure that they meet the requirements of the Canadian context. As noted in the chapter, the analysis and disclosure processes will continue to rely heavily on judgment, as each suspected case of money laundering, terrorist activity financing, or threat to the security of Canada must be assessed on its own merit.

Restrictions on the information that may be disclosed limit the value of disclosures

2.38 The *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* permits disclosure of "designated information" when it passes the threshold for "reasonable grounds to suspect" that the information would be relevant to investigating money laundering or terrorist financing. "Designated information" under the Act includes a transaction's date and place, its value, and the associated account numbers and names of the parties involved—so-called "tombstone" information.

2.39 When a disclosure is related to an ongoing investigation, it can contribute much useful support by providing new leads and helping to "chase the money," as one law enforcement officer put it. Otherwise, law enforcement and security agencies generally find that the information FINTRAC discloses is too limited to warrant action. Police forces in large urban centres, in particular, are already too swamped by their own investigations to take on new cases based on FINTRAC disclosures. Unless they concern an ongoing case, most disclosures are simply added to the recipient police force's database as possible future intelligence.

2.40 Law enforcement officers told us that suspicious-transaction reports they receive directly from banks often contain more useful information than

FINTRAC disclosures—they are more current and provide the reasons for suspicion. This is a serious criticism of a system set up expressly to add value to the raw information provided by reporting entities.

2.41 Finance Canada chairs a working group—which includes FINTRAC and law enforcement—that is exploring the possibility of adding telephone numbers, publicly available information such as names of a company's directors, and other information to FINTRAC disclosures to make them more useful. However, what the disclosures lack most is context: What led FINTRAC to suspect the presence of money laundering or terrorist financing? Without that context, law enforcement agencies are reluctant to devote scarce resources to an investigation that could lead to a dead end.

2.42 Legislation provides that law enforcement and security agencies who want more information from FINTRAC may apply to a judge for a "production order" to access additional details on transactions and the analysis supporting the disclosure. Only two such requests have been submitted to date; both were granted.

2.43 Law enforcement and security officers we interviewed cited two basic reasons for the reluctance to apply for production orders. One is that the legislative threshold is high, the same as for a search warrant: the applicant must satisfy the court that there are "reasonable grounds to believe" an offence has been committed. A search warrant is preferable because FINTRAC provides only intelligence, whereas a search warrant provides direct access to a target and to information that could be used as evidence. Moreover, the information contained in FINTRAC disclosures is generally considered below the legislative threshold that a production order requires.

2.44 Disclosures are hand-delivered to recipients, in part for security reasons; this also gives FINTRAC liaison officers more opportunity to develop contacts with law enforcement and security agencies, explain FINTRAC's mandate, and get feedback. In practice, though, this opportunity is severely limited by procedures that strictly prohibit the liaison officer from discussing any details of the disclosure beyond what is in the delivery package or venturing an opinion on what led FINTRAC to believe there are reasonable grounds to suspect that the information is relevant to money laundering or terrorist financing.

2.45 The law enforcement and security officers we talked to all appreciated the need to safeguard privacy rights, but several thought FINTRAC's interpretation of "designated information" might be excessively restrictive. The intent of the legislation is to protect privacy rights by prohibiting disclosure of information unrelated to a suspicious activity—but should disclosure of information on what makes an activity suspect also be prohibited? As long as FINTRAC continues using that interpretation, the value of its disclosures to law enforcement will remain limited.

2.46 **Recommendation.** The government should carry out a review to identify changes that would improve the value of FINTRAC disclosures and the means to bring about those changes.

Finance Canada's response. As noted in the chapter, the Department of Finance is chairing a working group of several Initiative partners to examine ways to improve the effectiveness of FINTRAC's disclosures.

The working group may identify possible operational improvements that could be made. Should there be proposed legislative amendments, the Department of Finance would look to the upcoming legislative reviews of Bills C-36 and C-22 as the appropriate venues for parliamentarians to consider recommended changes.

More needs to be done to encourage submission of voluntary information reports

2.47 Voluntary information reports from law enforcement and security agencies are an important source of intelligence for FINTRAC, and the agency promotes such reporting. Its liaison officers are instructed, when delivering disclosures, to advise recipients of the value of voluntary information reports to FINTRAC's analysis and its ability to determine that there are reasonable grounds to suspect money laundering or terrorist financing.

2.48 Indeed, though voluntary information reports make up only about two percent of the total of suspicious transaction and voluntary information reports, they contribute to two thirds of the disclosures FINTRAC makes. And those are the disclosures that law enforcement and security agencies find are most useful to their investigations and save them valuable time in confirming findings.

2.49 Yet law enforcement agencies are often reluctant to submit voluntary information reports because they are uncertain how FINTRAC will use the information. One agency told us that it hesitates to give FINTRAC information on ongoing investigations, out of concern that the investigations could be compromised. Another told us that it tends to submit voluntary information reports toward the end of an investigation, when it is about to close a file for lack of sufficient evidence. A third said that it does not submit voluntary information reports because it expects little back from FINTRAC.

2.50 Indeed, in most cases a law enforcement or intelligence agency submitting a voluntary information report hears nothing further from FINTRAC, due to the legislative restrictions on the information it can share. Of 713 voluntary information reports submitted to FINTRAC to the end of March 2004, 113 had resulted in return disclosures. In the remaining 600 cases, the agency submitting the report had no way of knowing whether FINTRAC was still working on the case or lacked meaningful additional intelligence to meet its threshold for disclosure. Unless FINTRAC has information that does meet its disclosure threshold, it simply sends nothing back. Its position is that outside of "designated information" determined to be relevant to money laundering or terrorist financing, the law prohibits any communication about the voluntary information report—not even an acknowledgement of receipt.

2.51 To a law enforcement or security agency, this situation is clearly unsatisfactory. It would like to know whether FINTRAC is working on a

report that it submitted and, if so, when it might expect a related disclosure. Such knowledge would minimize the possibility of closing a case prematurely on the assumption that FINTRAC had nothing to report. Or it could help the agency decide to terminate a case rather than wait for information that FINTRAC is not going to provide. In either case, valuable police time and resources would be saved. As the law now reads, however, FINTRAC is apparently prevented from communicating the status of a voluntary information report to the agency that submitted it.

2.52 In our view, even within the existing legislative framework the voluntary information report process can be made more transparent and useful. It should be possible for FINTRAC to establish target turnaround times for voluntary information reports it receives and to make those targets public. Currently, it has no such timeline targets, even though one of its stated objectives is the delivery of timely financial intelligence. Explicit, publicly reported targets would reduce the present uncertainty for law enforcement and security agencies and could also motivate FINTRAC to return information in a shorter period of time than it often takes now. Making the voluntary information report process more useful to law enforcement and security agencies would, in turn, encourage them to use it more.

2.53 Law enforcement and security agencies would also be encouraged to submit more voluntary information reports if FINTRAC used a standard electronic format, as it does for suspicious-transaction reports. This is an option that FINTRAC has considered but has not yet adopted.

2.54 **Recommendation.** FINTRAC should establish target turnaround times for voluntary information reports it receives from law enforcement and security agencies and should make those targets public.

FINTRAC's response. FINTRAC will establish target turnaround times by which it will give notice to domestic disclosure recipients (law enforcement, CSIS, and other government agencies) of the status of the voluntary information they have provided.

Limited feedback is provided to reporting entities

2.55 Evaluation and feedback are important means for improving the quality of transaction reports to FINTRAC and hence their usefulness. Effective monitoring of money laundering and terrorist financing therefore begins with the reporting entities—dealing directly with customers and handling transactions puts them in the best position to notice unusual activity and identify suspicious transactions. But they must know how to spot such transactions and report them properly.

2.56 FINTRAC has an extensive outreach program to help the parties who are required to report understand and meet their obligations, but it gives them limited feedback on the reports they provide. Over the past year, it has made presentations to individual banks upon request, providing information on reporting trends and on the contribution the bank's reports have made to FINTRAC disclosures. Publicly available feedback, which could benefit all reporting entities, is limited to the number of reports FINTRAC receives by

reporting sector. Representatives of reporting entities we talked to wanted more feedback, and we believe that more can be provided.

2.57 While legislation prevents it from giving feedback on how it has used specific reports, FINTRAC should be able to provide information by sector on the quality of reports, typical reporting errors, and attributes of a good report. It should also be able to provide summary information on how the reports it receives are used and to what benefit. More feedback of this kind could help reporting entities improve the quality of their reports and strengthen their commitment to the reporting process by demonstrating the benefits of the efforts and resources they have invested.

Backlog of reports on cross-border movements of currency limits their intelligence value

2.58 The legislation provides that all cross-border transfers of currency or other monetary instruments valued at $10,000 or more must be reported to a customs officer. Customs inspectors have authority to seize unreported currency. If the money is suspected to be the proceeds of crime, it is "seized as forfeit."

2.59 Customs officers collect these reports and forward them to the Database Section of the Canada Border Services Agency (CBSA) at its headquarters in Ottawa. There they are entered into an automated system using entry fields specified by FINTRAC, and the reports are sent to FINTRAC.

2.60 Reporting of cross-border currency transfers became a requirement on 6 January 2003. According to the CBSA, it had collected over 60,000 reports by the end of March 2004 and made 1,521 currency seizures, totalling more than $46 million. In 224 of those cases, the currency was forfeited as suspected proceeds of crime or funds for terrorist financing, yielding some $17 million to the Crown.

2.61 The Canada Border Services Agency told us that the volume of reports and the resource levels needed to enter data for transmission to FINTRAC are considerably higher than originally anticipated. In addition, incompatible software and security firewalls between the two agencies have led to extended downtime and slow transmission of information. While reports resulting from enforcement actions such as currency seizures are processed on a priority basis, at the time of our audit a nine-month backlog of reports submitted by compliant travellers and businesses awaited data entry at CBSA headquarters in Ottawa.

2.62 FINTRAC and the CBSA are working to resolve the connectivity problems between their information technology systems. Also, in September 2004 the CBSA hired two additional data entry clerks to help eliminate the backlog of unprocessed reports.

2.63 Until the backlog is cleared, potentially valuable intelligence will remain unused in the fight against money laundering and terrorist financing.

Disclosure of cases related to tax evasion is insufficient

2.64 The legislation requires FINTRAC to disclose designated information to the Canada Revenue Agency if it determines that, in addition to money laundering or terrorist financing, the information suggests possible tax evasion.

2.65 Of 301 disclosures FINTRAC made to the end of March 2004, it made only three to the Canada Revenue Agency, two of which related to the same target. This disclosure rate appears to be unusually low.

2.66 It is important that FINTRAC provide information to the Canada Revenue Agency because often where cases do not meet the threshold for criminal prosecution, civil liability for unpaid taxes may be possible. At any rate, FINTRAC must ensure that it makes such disclosures when information merits it, because it is required by law to do so.

2.67 **Recommendation.** In consultation with the Canada Revenue Agency (CRA), FINTRAC should establish criteria for disclosure to CRA of cases involving possible tax evasion and should refer cases to the CRA that meet the criteria.

FINTRAC's response. The Canada Revenue Agency and FINTRAC are working together to define and establish indicators that would enable FINTRAC, once it has reasonable grounds to suspect that its information would be relevant to a money-laundering or terrorist-activity financing offence, to more readily determine whether the information would also meet the separate statutory test of being relevant to an offence of evading or attempting to evade taxes. FINTRAC and the CRA have been working together to design and deliver a workshop on indicators and typologies for staff from both agencies at the earliest opportunity.

Canada Revenue Agency's response. The Canada Revenue Agency fully agrees with this recommendation. The development of the criteria for disclosure of possible tax offences is a priority for the CRA and we are prepared to proceed expeditiously.

Compliance

2.68 FINTRAC is responsible for ensuring that all entities subject to the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* comply with their obligation under the Act to report certain transactions, keep records, identify clients, and implement an effective system of compliance.

2.69 FINTRAC's compliance function comprises three types of activity:

- outreach, to encourage reporting entities to comply;
- monitoring, to verify compliance; and
- referrals to law enforcement, to deal with willful non-compliance.

Outreach to reporting entities is extensive but provides little strategic intelligence

2.70 FINTRAC's approach to compliance is built on partnership and the assumption that reporting entities are willing to comply. It therefore concentrates heavily on education and outreach efforts to make sure that

reporting entities are aware of the requirements of the legislation and comply with them.

2.71 Measures FINTRAC uses to promote awareness and compliance include

- guidelines, advisories, pamphlets, press releases, and an annual report, all of which are available on its Web site;
- presentations to individual reporting entities and at industry conferences across the country; and
- consultations with reporting entities and their associations.

2.72 FINTRAC has established a working group for each reporting sector and a framework to formalize consultations with each sector. Its ongoing consultations with the Canadian Bankers Association have significantly improved its relationship with this key business sector. Outreach efforts have been less effective with insurers, securities dealers, and real estate agents, in part because they do not see that money laundering is relevant to them, despite evidence to the contrary.

2.73 This misconception reflects the need for more concrete, specifically targeted information on money laundering and terrorist financing. Up-to-date reports on techniques and trends in specific sectors can help reporting entities understand their own risks and where they might be vulnerable. Publishing cases of money laundering and terrorist financing, in a sanitized form if necessary to safeguard personal privacy, would also help increase awareness and improve compliance and reporting.

2.74 As FINTRAC points out in its latest Report on Plans and Priorities, it is "uniquely positioned to provide strategic intelligence on broad trends and emerging developments in money laundering and terrorist activity financing to partners and stakeholders engaged in anti-money laundering and anti-terrorism efforts." To date, however, it has taken little advantage of this position to develop and disseminate strategic intelligence. Representatives of reporting entities and law enforcement agencies told us they would welcome such "big picture" information and were disappointed that FINTRAC was not providing it. FINTRAC says the reporting regime is still young and it is too soon to draw conclusions.

Unregulated reporting entities pose significant compliance challenges

2.75 Compliance with anti-money-laundering requirements by federally regulated life insurance companies and deposit-taking institutions is assessed by the Office of the Superintendent of Financial Institutions (OSFI). OSFI has been issuing guidance since 1990 on sound practices for deterring and detecting money laundering. As part of supervising regulated financial institutions, OSFI reviews the adequacy of their anti-money-laundering practices and procedures and their compliance with the legislation. Provincial regulatory agencies perform similar supervision of provincially regulated institutions.

2.76 To make the best use of its own resources and minimize duplication of effort, FINTRAC intends to rely on federal and provincial regulators for the primary monitoring of regulated institutions. Legislative amendments that allow FINTRAC to share compliance information with regulators came into effect on 1 June 2004, and FINTRAC has already signed a memorandum of understanding with OSFI that provides for such information sharing. FINTRAC is negotiating similar arrangements with provincial regulators, and moving forward on this is critical—the more closely the opportunities for money laundering are monitored at the federal level, the more incentive there is to move money-laundering activities to the provincial level.

2.77 The unregulated sector poses significantly bigger compliance challenges. It includes accountants and real estate agents, who at least are licensed and subject to some monitoring by their professional associations. But it also includes money service businesses, which—apart from their obligations under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*—are neither licensed nor regulated. Indeed, there are no reliable figures on how many such firms exist. FINTRAC has attempted to build an inventory from telephone directories and newspaper ads, but the task is next to impossible: many money services are a part of other businesses such as travel agencies, small grocery stores, and gas stations; and they might not advertise. Complicating the task further, these services go in and out of business at a high turnover rate.

2.78 The Financial Action Task Force on Money Laundering recommends that money service businesses be registered as a means of keeping track of them. Several countries, among them the U.S. and the UK, require these businesses to register. But the need for federal/provincial co-operation to implement an effective registration system complicates this option for Canada more than for most other countries.

2.79 There is a concern that requiring them to register may drive some of these businesses underground, although legitimate businesses would likely welcome the requirement. At present, a money service business may find that banks are reluctant to deal with it because they cannot be sure that it is complying with requirements related to money laundering and terrorist financing.

2.80 Registration would make it easier to monitor compliance by generating a list of licensed money service businesses; communication would also be easier. Finance Canada, with its Initiative partners, is considering options for licensing or registering money service businesses.

Enforcement mechanisms are incomplete

2.81 Along with outreach and monitoring, an effective compliance system also needs the capacity to impose appropriate penalties when reporting entities demonstrate willful non-compliance. The *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* provides for penalties of up to five years in prison and up to $2 million in fines for non-compliance.

2.82 With many more reporting entities than resources available to monitor their compliance, enforcement action is critical to deterring non-compliance. People we interviewed in this audit pointed out that penalties in Canada are already more lenient than in the U.S. If a perception develops that enforcement is also lax, compliance will suffer.

2.83 This is not news to FINTRAC. An internal report in May 2003 argued that the lack of enforcement was creating a competitive inequity that had to be addressed "to ensure that those who invest in compliance are not disadvantaged in the marketplace by having implemented compliance programs compared to non-compliers who have not invested."

2.84 Part of FINTRAC's compliance program calls for the development of policies and procedures for referring cases of non-compliance to law enforcement. At the time of our audit, these policies and procedures were still being developed and no referrals had been made. Outreach and education promote compliance by entities that are willing to comply; but when education fails, FINTRAC must be prepared to take the next step.

Performance measurement and reporting

Information on the Initiative's effectiveness is limited

2.85 Soon after the National Initiative to Combat Money Laundering received legislative approval in June 2000, Finance Canada in collaboration with the other Initiative partners prepared a comprehensive evaluation framework to assess the appropriateness of the funding levels. The framework had two stages: a limited assessment in the third year of the Initiative would focus on program design and implementation, and a more extensive evaluation in the fifth year would assess the impacts of the Initiative compared with the anticipated outcomes. In addition, section 72 of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* provides that the administration and operation of the Act be reviewed by a parliamentary committee within five years of that section's coming into force, that is, by 5 July 2005.

2.86 However, timely information on the ongoing performance of the Initiative is also needed to manage it and meet accountability objectives. The Treasury Board requires that departments and agencies measure program performance, relate it to program objectives, and report on results achieved. Indicators by which to measure performance are to go beyond activities and outputs to outcomes. Weighed against these requirements, the information on the Initiative that has been collected and reported to date is limited.

2.87 The Initiative's basic purpose is to detect and deter money laundering and terrorist financing. That is how FINTRAC, as a central player in the Initiative, defines its own strategic outcome. Yet the performance indicators it has set out in its Strategic Plan and Departmental Performance Report are mostly measures of operations—for example, numbers of reports received, disclosures made, compliance initiatives introduced, contacts made with stakeholders, and memoranda of understanding signed. Even for these,

FINTRAC has set no targets or expectations that could be used by management to know whether it achieved what it set out to achieve, and by Parliament to assess the agency's performance.

2.88 FINTRAC attributes this focus on the operational level partly to its status as a young agency, still developing. It says it will be shifting its emphasis to the impact of its products and activities. In January 2004, its Executive approved an Integrated Performance Management Framework designed to identify key measures of performance and develop appropriate systems to collect the necessary data. Based on a "scorecard" model, the framework is expected to provide benchmarks and indicators that will inform management each quarter of results achieved relative to established targets. Development of the framework was under way at the time of our audit, with completion targeted for the end of September 2004.

2.89 Much of the information that FINTRAC needs to assess its performance comes from outside the agency. Financial intelligence that it provides to law enforcement and security agencies through case disclosures is FINTRAC's main product. It needs feedback on these disclosures in order to know how they are being used and what difference they make. In 2003, FINTRAC set up a working group to develop options for collecting feedback on disclosures, but feedback remains largely anecdotal and episodic.

2.90 Early in 2004, the RCMP's Financial Crimes Branch agreed to put arrangements in place to track the status of cases disclosed by FINTRAC and report to it regularly. FINTRAC does not yet have any similar arrangements with other law enforcement and security agencies.

2.91 Information on actions taken in response to FINTRAC disclosures is necessary not only so that FINTRAC can assess its own performance but also so the performance of the Initiative overall can be evaluated, since those disclosures are the Initiative's main product. It is not possible to assess the Initiative's effectiveness without information on the impact that FINTRAC disclosures have had on the investigation and prosecution of money-laundering and terrorist-financing offences. All partners in the Initiative thus have a shared interest in co-operating to establish mechanisms for tracking the use of FINTRAC disclosures and measuring their effects, to the extent that is possible. For accountability purposes, summary information on these results needs to be reported to Parliament regularly.

2.92 **Recommendation.** The government should establish effective mechanisms for monitoring the results of disclosures, including the extent to which disclosures are used and the impact they have on the investigation and prosecution of money-laundering and terrorist-financing offences. It should report summary information on these results to Parliament regularly.

Finance Canada's response. Many of the initiative partners have already begun to put in place various tracking systems that will provide greater feedback on the use and impact of FINTRAC disclosures. As well, FINTRAC is currently discussing methods to track disclosures with provincial and municipal police forces.

The Department of Finance will consider the value of how often to report to Parliament. Additional reporting would have to complement the existing reporting requirements of Initiative partners, the upcoming agenda of parliamentary reviews, and the requirements for periodic evaluations of the Canadian anti-money-laundering and anti-terrorist financing regime by the Financial Action Task Force.

Conclusion

2.93 The National Initiative to Combat Money Laundering is relatively new, and the elements required for its effective implementation and accountability to Parliament are not yet fully in place. Certain design features also constrain the capacity of the Initiative to deliver on its main objective of detecting and deterring money laundering and terrorist financing.

2.94 **Disclosure of financial intelligence.** Legislative restrictions limit FINTRAC's ability to provide good-quality financial intelligence on money laundering and terrorist financing. Information that FINTRAC is permitted to disclose can be useful when it relates to a current investigation, by corroborating findings or providing new leads. Otherwise, law enforcement and security agencies normally find that the information FINTRAC discloses is too limited to warrant action. In short, as the system now works, FINTRAC disclosures can contribute to existing investigations but rarely generate new ones.

2.95 **Compliance.** FINTRAC has an extensive outreach program to help reporting entities understand their obligations. However, it provides limited feedback on the reports it receives from them, and little information on trends in money laundering and terrorist financing to help them identify suspect transactions and produce better reports. Moreover, FINTRAC has not fully implemented policies and procedures to monitor and ensure these entities' compliance with legislative requirements. The exemption of legal service providers from reporting requirements also undermines the system's effectiveness.

2.96 **Accountability mechanisms.** Appropriate mechanisms to track the use of FINTRAC disclosures have not been implemented by all recipients of disclosures. In the absence of a comprehensive system of monitoring the use of disclosures, FINTRAC cannot assess the value of the intelligence it provides and how it can be improved. And it is equally impossible to assess the overall performance of the Initiative and its impact on money laundering and terrorist activities in Canada.

2.97 Our audit identified a number of government actions needed to make the Initiative more effective:

- Broaden the kinds of information that FINTRAC may disclose, within limits that respect the privacy rights of Canadians.

- Implement a management framework to provide direction and strengthen the co-ordination of efforts within the federal government and with stakeholders at other levels of government and in the private sector.
- Establish accountability structures to ensure that the information needed for measuring the Initiative's performance is collected and that results are reported to Parliament regularly.

2.98 Legislation calls for parliamentary review of the Initiative by 5 July 2005. The parliamentary committee conducting that review may wish to look at these issues and at whether lawyers are still exempt from the anti-money-laundering legislation, as they have been since March 2003 following successful legal challenges.

About the Audit

Objectives

The objectives of the audit were to determine whether the management framework for implementing the National Initiative to Combat Money Laundering

- is appropriately designed to promote detection and deterrence of money-laundering and terrorist financing, and
- provides accountability to Parliament for results achieved.

Scope and approach

FINTRAC and its operations were the focus of the audit, although we also examined the anti-money laundering activities of other partners in the Initiative and in particular their relationship to FINTRAC.

The audit assessed whether the government has developed and put in place mechanisms, systems, and procedures to

- produce and disseminate good-quality financial intelligence on money laundering and terrorist financing,
- ensure compliance with anti-money-laundering and terrorist-financing requirements,
- collect data on results achieved, and
- measure and report on performance.

We built on the knowledge base established during our April 2003 study of the government's strategy to combat money laundering. We also reviewed relevant literature, laws and regulations, and international standards on measures against money laundering and terrorist financing. We examined disclosures made to law enforcement and security agencies and foreign financial intelligence units (including the analytical reports supporting these disclosures). We analyzed data and reviewed departmental documents, surveys and evaluations, management files, and reports. We also interviewed departmental and agency officials and representatives of law enforcement agencies (federal, provincial, and municipal police forces), as well as officials of federal and provincial regulatory agencies and representatives of reporting entities.

Audit team

Assistant Auditor General: Doug Timmins
Principal: Basil Zafiriou
Director: Richard Domingue

Rose Pelletier

For information, please contact Communications at (613) 995-3708 or 1-888-761-5953 (toll-free).

Report of the Auditor General of Canada to the House of Commons—November 2004

Main Table of Contents