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Preventing Money Laundering: Key to a Better World

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Table of Contents

Abstract

Money laundering has developed over recent decades and has evolved into a worldwide phenomenon. Virtually every country in the world is affected by money laundering. The methodology of money laundering exists in every fraud scheme. It involves the concealed transfer of assets by masking them in the ordinary normalcy of financial transactions. Money laundering is a criminal enterprise, with the emphasis on the business aspect. The attraction of perpetrators into the money laundering business is profit with little perceived risks. This paper discusses money laundering, how to define it, its origins, the cycle, its effects, prevention methods, and what the United States currently has in place to help prevent and discover fraudulent transactions. Additionally, it discusses Hawalas, electronic payments, money laundering from an international perspective, how the Bank Secrecy Act evolved and the rise of the Patriot Act. Suspicious activity reports, Money Service Business (MSBs) and Currency Transaction Report (CTR) are also discussed.

Introduction

Money laundering is a crime with significant consequences to our world. Every year, vast amounts of funds are generated from illegal activities such as human trafficking, drug trafficking, tax evasion, theft, arms trafficking, and corrupt practices. The funds generated by these activities are usually in the form of raw cash. The criminal who generates these funds needs to bring them into the public financial system without raising suspicion by posing them as legitimate transactions. The conversion of cash into other forms makes it more usable and easier to handle. For example it is easier to carry a small bag of diamonds as opposed to a suitcase full of cash even though they represent the same value. Moreover, individuals can sometimes sell their products at a higher price and end up making a profit. Additionally, by converting cash into other forms, perpetrators are putting physical distance between themselves and the illegal activities.

It is estimated that trillions of illegal funds are laundered worldwide each year (AUSTRAC, 2011). There are many reasons why people laundered money, some do it to hide wealth, avoid prosecution, evade taxes, increase profits or become legitimate. The result of their actions is that they undermine financial systems. Money laundering undermines the financial system and raises questions of credibility and transparency. Money launderers also encourage crime because they enable criminals to effectively use and deploy their legal funds. Criminals can increase profits by reinvesting the funds they acquired through illicit means into illegal businesses. Furthermore, another consequence of money laundering includes reduced revenue and control. Money laundering diminishes governmental control over the economy because it reduces government tax revenue.

By combating money laundering, the power that criminals have can be diminished. This serves to weaken criminal organizations and reduce crime. For example, if it become very difficult for drug traffickers to utilize the funds generated through illicit activities like drug/human trafficking, these activities are likely to diminish (AUSTRAC, 2011).

Literature Review

Money laundering is one of the most common and generally misunderstood financial activities. It is connected to various illicit financial schemes which can include fraud, tax evasion, narcotics, human smuggling, corporate fraud, terror financing, and governmental corruption. Some style of money laundering exists in every fraud scheme. It involves the concealed transfer of assets by masking them in the ordinary regularity of financial transactions. Money laundering originated from Mafia ownership of laundries in the United States. Gangs utilized Laundromats specifically because they were a cash business. Gangs generated illegitimate cash from various sources including: extortion, prostitution, gambling, and other enterprises to purchase legitimate businesses in hopes of aiding in the funneling of illicit goods (Turner, 2011). Money laundering involves the use of traditional business practices to move funds throughout the world.

The money laundering cycle usually involves three major steps: (1) placement, (2) layering, (3) integration (Turner, 2011). Placement is where the cash is generated. It can be any activity that generates the cash that the person wants to hide. It can include the sales of legal or illegal products, the acceptance of improper payments, or the removal of company assets. Usually the result is cash, which could implicate the individual unless its origins can be disguised. To obscure the path, money may be shipped to foreign financial organizations or used to buy works of art or other high–value items such as aircraft, boats, precious metals and jewelry.

The second step in the process is layering the funds. Layering is stratifying the financial transaction. The more layers that are added to the process, the harder it will be to prove the illicit basis for the funds. Examples include shifting funds from account to account or moving them from institution to institution. Once they are inside the system, it is easier to move them around.

Layers often include various financial accounts, high-value items, currency and equipment sales, and the purchase of real estate and legitimate businesses, particularly in the leisure and tourism industries. This may also involve shell companies to help layer the transactions.

The final step is Integration, in which the funds are assimilated back into the perpetrator's public accounts. Once the funds are layered and distanced from their origins, they are made available for activities such as investment in legitimate or illegitimate businesses, or spent to promote the criminal's lifestyle. One such form can be by the utilization of consultants, even though the consultant might not even exist. For example, the criminals could actually pretend to be the consultant themselves. In this case, the criminal is channeling money directly back to him/herself. The money is declared as income from services performed and can be used as legitimate funds. Other times, the criminals will employ an actual consultant to do some legitimate work. This could involve purchasing assets. The criminal can then transfer funds to the consultant's client account from where the consultant makes payments on behalf of the criminal (Integration). Other examples of integration techniques include standard bank accounts, bonds, stocks, money markets, and/or corporate accounts.

Accounting professionals often miss the larger picture of money laundering. It is important to understand the meaning, role, and history of this kind of activity to see how it began and evolved to impact a wide range of business functions. Money laundering involves the use of traditional business practices to move funds. It is a criminal activity in which the emphasis is on the business aspect, as opposed to more violent approaches. Individuals who engage in this type of activity generally do so for the high profit potential. They perceive it as making a profit with little apparent risk.

Meyer Lansky developed the concepts behind the modern day money laundering approach. After a famous criminal, Al Capone, was convicted for tax evasion, Lansky set about searching ways to hide the money. He used cash from crimes committed in the United States and took it to Switzerland where he would loan it back to entities owned or controlled by the various illegal gangs (Turner, 2011). Lansky utilized the "loan back" concept, in which illegal money is disguised by loans provided by accommodating foreign banks. By utilizing the facilities offered by the banks of Switzerland, Lansky's fraudulent gains were disguised as loans. He later declared them as revenue, and was able to receive a legal tax deduction.

The expression of Money laundering was first used in 1973 on newspapers reporting on the Watergate Scandal. The financial trail of check clearances connected the burglars who broke into the Democratic National committee headquarters to Nixon's campaign, and eventually led to President Nixon himself. The first judicial use of the term was context in 1982 when the Money Laundering Control Act was passed (Sharman, 2011). Today, Lansky's approach is one of the more popular mechanisms for laundering cash. It allows the beneficiary to document, declare, and utilize cash while providing limited recourse for government investigators

People looking to hide the movement of funds are interested in two primary things: (1) safety and (2) secrecy. They are looking for mechanisms that will allow them to move the money with minimal risk of loss and keep the knowledge of those movements hidden from apparent adversaries, such as law enforcement, family members or other rivals (Turner, 2011). A fraudster from the 1990s, Walt Pavlo, at one point describes knowing what the auditors would look for and providing them with distractions to keep them away from the assets he was hiding. Pavlo did this because not only was safety of the funds important to him but also to not be discover by the auditors, in order words, to maintain secrecy.

Criminal organizations want to make sure that the funds they are funneling are safe from third parties. These third parties can be governmental oversight bodies, rival organizations, and independent auditing firms. Perpetrators of economic crime go through great lengths to design methods or systems in which they keep the cash on hand safely guarded throughout the entire process of integrating money into the public sector financial system. They also run through various potential simulated money exchanges and perform risk analysis on each piece of the path. This serves to allow the perpetrators a look into the probabilities of possible funneling mishaps, which influences their decision on exactly which method to use to integrate the money into the system. Overall, perpetrators seek methods which will not raise red flags during any financial transaction that could possibly alert authorities as to their intentions.

In addition to hiding the path of the money, perpetrators of economic crime work hard to hide the source and destination of the money from all interested governmental, rival, and third parties. After the ill-gotten cash has been obtained, perpetrators do not want anyone to be able to tie this large amount of cash directly to them. If any other party is able to tie the source of the funds to a perpetrator, then this can serve as evidence of criminal activity, and could be used against them in a court case. Additionally, if the funds can be classified at the destination as laundered money, then this will trigger an investigation which can lead back to the source of the money. Therefore, perpetrators value very highly the art of hiding where the laundered funds come from, where the laundered funds go, and which exact organization the funds belong to.

Perpetrators facilitate their successful transaction operations in several ways. Several key individuals are essential for the entire operation to be successful. Sometimes, the skilled individuals in these positions are people with high integrity, in other cases they are not. Business owners, dirty or unethical accountants, or any individual needed to set up shell companies, fictitious sales, or any illegitimate enterprise constitutes a potential money laundering operator. For example, in a fictitious for-profit enterprise, money laundering operators used compensation, coercion, bribery, and other forms of illicit pressure to induce otherwise law abiding citizens to become participants in this scheme. Forcing ordinary individuals against their will to act on the operator's behalf serves to further produce the appearance of legitimacy and concealment for the money laundered.

To decrease the likelihood of illicit activities, the United States government has created sanctions and a regulatory environment to oversee the public marketplace. However, there are unintentional effects that sanctions and regulatory oversight can have on the market place. Pressure was applied by the government to the banking system because banks, like other financial institutions, are themselves subject to the Bank Secrecy Act and are required to monitor their customers for money laundering activities by applying a level of scrutiny commensurate with the level of money laundering risk each customer presents (Watterson, 2013). However, this increased level of regulation and oversight does not come without cost to the market and individuals. In December 2011, there was a controversy over the closure of Hawalas.

Hawala is an informal value transfer system based on the performance and honor of a huge network of money brokers. They are primarily located in the Middle East, Africa and the Indian subcontinent. It is similar to the remittance system that traditional banking institutions utilize. Hawalas defined means "transfer of money without money movement" which indicate a transfer of money without actually moving it (Hawala, 2013). Hawalas work by a customer approaching a Hawala broker and gives them a sum of money to be transferred to the intended recipient in another place. A password is usually specified. The Hawala broker then informs another associated Hawala broker in the specified city about the request for movement of the funds and the password. Meanwhile, the client communicates this password to their intended recipient. This intended recipient then approaches the secondary Hawala broker and, after providing the correct password, the funds are then released to the recipient, minus a small transaction fee. The money has not actually moved, but there is a promise to settle the debt between Hawala brokers at a later date. This debt could be kept for future payments in the opposite direction, or could be repaid via a variety of means, including physical transfer of goods, or the execution of special services for the debtor. Every phase of this process is informal, and is governed by special record books which are not readily available for audit as well as primarily dealing with money transfers; these make them especially susceptible to money laundering activities.

Minnesota, home to the largest Somali-American population in the country, recently was the center of attention over the closure of Minnesota based Hawalas. Hawalas were closed because their bank closed the Hawalas' accounts, thus making it difficult to directly send actual money across the globe. According to the bank's statement, it was determined that the Hawala system lacked the capacity to ensure that funds wired by the bank did not end up in the hands of terrorist organizations. The fear of liability by a bank that believed it could not screen its customers to the satisfaction of regulators led to the canceling of the service, despite being in full compliance with all relevant state and federal laws. This took a useful and often essential system out of commission, and can be an example of an unintentional effect which sanctions and regulatory oversight can have on the market (Watterson, 2013).

The development of electronic payments has contributed towards the expansion of illegal transactions due to the easiness it provides, as well as because of decreased face-to-face contact. The rise of the internet has become a supportive environment to creating legitimate funds from illegal sources through electronic wire transfer methods such as internet banking and online gambling among others. As electronic technologies become more advanced, the ways in which criminals utilize them for money laundering are also becoming extremely complex. Activities in which money laundering operators participate in include credit card theft, phishing, direct hacking, and stealing passwords through key loggers, all in support of their money laundering schemes. A particular method of money laundering through Internet currency is through the use of a smart card. It has attached a microchip that stores the value of the card. This system is designed to provide the transacting parties with immediate, convenient, secure and potentially anonymous means by which to transfer financial value (Popa, 2012).

While a small portion of laundered funds are intended to be hidden for some period of time, the eventual purpose will be for the initiator to publicly use the funds. There are several ways to utilize the funds: they can finance rogue political, religious, social, or economic operations and groups, they can add the cash into their personal accounts, or they can use the funds to further finance more complicated criminal operations and businesses, among many others. There are two ways money laundering can be looked at. Some organizations have a large need for money to finance their operations, so they must look at various means of raising and acquiring capital, which often leads them to resort to money laundering to retrieve these funds. However, there are other organizations which have already acquired large amounts of capital through existing criminal operations, and now seek means by which to use these funds in the public sector. While each case differs in approach to money laundering, both use the same methods and strategies.

Generally, the idea behind money laundering is to "clean" the money from any ties to its illegal origins so that when used, there is no way it can be connected to the illegitimate business.

An example of such strategy is Renting Credibility. Renting Credibility is the use of legitimate types of transactions, otherwise legitimate entities, and involve otherwise legitimate intermediary purchases to create the appearance of legitimacy (Turner, 2011). An example of such can be utilizing the banking system to feed the cash into flow. A perpetrator can feed their illegal money into a bank account utilizing various forms of online internet payment services and then convert them into e-cash or electronic money. By utilizing small amounts, the banking system is very unlikely to suspect anything. Once the physical money has been converted to a digital form, it can be transferred anywhere. Due to the fact that is coming from a bank, other public sector and governmental entities are less likely to suspect anything because of the inherent credibility of banks.

Laws and Regulations

Money laundering is a global problem and, as such, there must be cooperation between all the countries of the world in combating money laundering. Since money laundering is part of transnational organized crime, the activities of the state agencies to prevent and impose sanctions on such crime always require the adoption of new strategies and methods to follow up the operators engaged in international money laundering. Such methods and strategies include the legal terms of extraditions, letters of request, enforcement of the final sentences issued by other states, seizure and confiscation proceeds for crimes committed abroad, and new ways of cooperating between national agencies of different countries (Popa, 2012). There have been a series of protocols and international agreements that establish ways to fight against trans-border criminals and operators engaged in money laundering. The starting point of the United Nations Convention in terms of money laundering occurred in Vienna 1988. The convention stated that "conversion or transfer of property knowing that it comes from one of the offenses set out above in this paragraph or concealing or disguising of the origins of the mentioned illicit goods or assisting of any person who is involved in the commission of this crime or trying to escape of the legal consequences of his acts," this statement condemned individuals involved with money laundering (Popa, 2012). After this event, the European countries adopted the convention on Laundering, Search, Seizure and Confiscation of the crime Product on November 8, 1990. Furthermore, additional international laws have been enacted which made law enforcement more effective in the fight against money laundering.

The United States has its own sets of laws when dealing with money laundering. The U.S introduced the Currency and Foreign Transactions Reporting Act of 1970, otherwise known as the Bank Secrecy Act. This act required U.S financial institutions to assist U.S governmental agencies to detect and prevent money laundering. The reason why this act focused on financial institutions is because they are better positioned than the government to detect money laundering and other financial crimes. Specifically, the act requires financial institutions to keep records of cash purchases of negotiable instruments, file reports of cash transactions exceeding $10,000 (daily aggregate amount), and to report suspicious activity that might signify money laundering, tax evasion, or other criminal activities (FinCEN, 2013). Because institutions are submitting reports and maintaining records of certain transactions, officials have a paper trail to follow. Congress created the Financial Crimes Enforcement Network from within the United States Department of the Treasure to implement, administer and enforce compliance with the authorities contained in the Bank Secrecy Act. When institutions notice unusual activity, they must notify the Financial Crimes Enforcement Network.

Since 1970, the constitutionality of the Bank Secrecy Act has being questioned three times, in 1974, 1986, and 1990. In 1992, it was decided that law enforcement needs more information on suspicious transactions to support financial investigations. Thus, the Annunzio-Wylie Money Laundering Suppression Act was enacted. This act required suspicious activity to be reported. Additionally, due to the focus by law enforcement on criminal abuse of Money Service Business (MSBs) and Currency Transaction Report (CTR) exemption process, and the burden on the financial community, in 1994, it was added that MSB registration and CTR filings be required. The Bank of Secrecy Act created an affirmative effect because it detected attempts at laundering drug proceeds or other crimes that involve large amounts of cash because it provides the system with many chances at detecting irregularities.

Furthermore, the Bank Secrecy Act brought improved cooperation and coordination between regulatory, financial and law enforcement communities by merging the treasury's office of

Financial Enforcement with the Financial Crimes Enforcement Network. Additionally, the Money Laundering and Financial Crimes Strategy Act outlined the national money laundering strategy. The High Intensity Financial Crime Area program was created. This program called for the designation of certain areas as areas in which money laundering and related financial crimes are extensive or present a substantial risk. A national strategy was developed where it concentrated law enforcement efforts at the federal, state, and local level to combat money laundering. This helped improve coordination of federal, state and local efforts and resources to combat financial crimes. In 2000 MSBs were required to file Suspicious Activity Reports (SARs) in order to provide law enforcement additional information on money transmitter and issues, sellers and redeemers of money.

After the terrorist attack at the World Trade Center and the Pentagon, the president announced the financial war on Terror. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism, otherwise known as the USA PATRIOT ACT of 2001, was enacted to deter and punish terrorist acts in the United States and around the world, to enhance law enforcement investigatory tools, and other purposes (FinCEN, 2013). The act required information sharing and provided registration requirements for underground money transmitters. Because the institutions are the front line against money laundering and terrorist financing, they received new or amended Anti-Money Laundering (AML) Program requirements. Moreover, Casinos were included in the list to file SARs, foreign shell banks were recognized as a threat and the termination of accounts for shell banks and certification by foreign correspondents were required. The USA PATRIOT ACT strengthened the U.S measures as it made subject to special scrutiny foreign jurisdictions, foreign financial institutions, and classes of international transactions or types of accounts that are susceptible to criminal abuse.

Revisions were made to enable financial institutions to expedite reporting process, reduce costs in complying with the Bank Secrecy Act requirements; the PATRIOT Act Communications System (PACS) was launched to allow financial institutions to file the Bank Secrecy Act reports electronically. In 2003, the need to protect more MSBs from financial crimes was discovered and thus Currency dealers and Exchangers were required to file SARs and strengthened the identification programs required for most financial institutions. Due to the increase of foreign agents, the U.S financial system needs additional protection from risks of finance crime posed by foreign agents. MSBs received guidance for dealing with foreign agents and foreign counterparts.

As the years progressed, legislators behind the Bank Secrecy Act and the PATRIOT Act considered other industries to protect against financial crime; Industries such as the Jewelry, insurance, and mutual funds. The jewelers, dealers in precious metals and stones, were required to establish anti-money Laundering (AML) programs. AML programs at a minimum must include: the development of internal policies, procedures, and controls; designation of a compliance officer, an ongoing employee training program, and an independent audit function to test programs. Additionally, certain insurance companies were required to establish AML programs as well as to file SARs. All mutual funds were required to file SARs. The Financial Enforcement Network enhanced due diligence by scrutinizing certain account services for foreign correspondent banks by requiring U.S financial institutions to maintain correspondent accounts for foreign financial institutions or private banking accounts for non-U.S persons.

Potential Solutions

After all the effort placed in Anti-Money Laundering Programs, there still exits an overwhelmingly amount of money being laundered. Not only that but, money laundering is a crime that is growing rapidly. One of the reasons why money laundering still exists today is because the established control processes do not translate well. The International community has a variety of legal and cultural systems that pose opportunities for failure in the control process. In addition, companies and individuals across the world have built complex tax structures in order to minimize taxes. These complex structures make it more difficult to see the transparency of the transactions and thus make it harder to detect illicit activity.

Additionally, countries around the world have different standards for how they deal with corruption and whether or not they fail to take matter seriously can create another area of exposure to money laundering. Individuals involved with international business or simply traveling abroad have a high chance of encountering bribery and corruption on a regular basis thus increasing the likelihood of engaging in illicit activities. As individuals are exposed to a wide range of new influences, they may be more susceptible to approaches from either curious individuals or criminals themselves. Moreover, many cultures do not regard some levels of corruption as wrong. For example, a business traveler that casually bribes the immigration officer to resolve issues with his or her visa is regarded from the perspective of an U.S citizen as having bribed the official. While in many developing countries this transaction may be simply regarded to as a form of gratuity for their service.

Individuals are human and as a result they can make irrational choices. Humans make mistakes, they respond differently under pressure and they react in accordance to their experiences, culture, values and traditions. Some individuals have no problem advancing in life through theft, embezzlement, abuse of trust, espionage, or other means if given a chance. The key is to mitigate possible instances of bribery and corruption. Furthermore, internal controls and Anti-Money-Laundering programs are designed to deter and detect wrongdoing but they depend on the integrity of the individual to be effective.

Human traffickers, drug traffickers and many other criminals are constantly trying to recruit individuals to help them launder their fraudulent gains. Many of these schemes are not recorded and as such require outside investigations. However, regular inspections by fraud detection professional can help ensure that the "on the books" records are clean and free from fraudulent activities. In addition to keeping the records clean, companies that are in high crime environment should steer away from getting involved with questionable activities, such as paying the official police or criminal gangs for protection.

By either reducing the level of underlying crime or by reducing the profitability of those crimes, governments can impact the overall crime culture. The Office of Economic and Environmental Activities began focusing on criminal activities in 2001 and have been expanding these initiatives ever since (Turner, 2011). This is a good start; however participating countries should plan initiatives that focus on the expansion of legislation, law enforcement, and regulatory structures, as well as the development of resources to identify and restrict money laundering activities. Rather than financial regulators, financial intelligence units with law enforcement functions should be expanded. Devoting specific resources to the security perspective will promote a more consistent approach and thus a dynamic response from the public.

Another possible solution to deter money laundry would be to include a mandated cap on nonfinancial system products such as cyber cash, smart cards, and reloadable traditional cards. Regulatory agencies could impose a total volume cap on these cards, allowing them to have a longer life cycle, but capping them from being used repeatedly for high-value transactions. The difference this action would make is to stop perpetrators from loading high values into these cards continually; thus, making it harder for individuals to insert their illicit-earned cash into the system.

Conclusion

Money laundering refers to the process by which illegal funds and assets are converted into seemingly legitimate funds and assets. Money laundering is a crime that must be deterred. It consists of networks that can be quite large and participants may consist of ordinary individuals whom otherwise one would not expect criminal activity from. Often, Intermediaries such as lawyers and bankers play a critical role in the process. Individuals such as these are able to manipulate the banking processes of account opening, monitoring, deposits, transfers and payments without arousing suspicion.

The funds for money laundering come from various activities, such as drug trafficking, tax evasion, human trafficking and other illegal activities. By laundering these illicit funds the role and power of criminals in substantially strengthened. Money Laundering provides severe economic and social consequences to the countries affected. Since it is such a vast criminal act, countries are uniting themselves to combat money laundering by creating Anti-Money Laundering programs. Additionally, the United States deals with it thorough the Bank Secrecy Act and the USA PATRIOT ACT.

By fully realizing the risks that a given organization can be involved with, the best possible solution will be found. An established control that translates well across different parts of the world should be produced, where standards levels of corruption are defined. Another possible solution to prevent money laundering is to place caps on nonfinancial systems. That way repeat abuse of the system is minimized. If money laundering is not stopped, perpetrators will become stronger and they will continue to corrupt society.

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