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The Prosecution and Confiscation of the Proceeds of Illicit Enrichment
The Prosecution and Confiscation of the Proceeds of Illicit Enrichment in Macedonia

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Disclaimer: All information on these slides is based on public information. No case or confidential information has been used on these slides. Examples have been taken from other countries (mostly UK) and similarity with actual cases is purely coincidental. This presentation contains graphics from the Internet provided under fair use laws.

These slides do not cover the Law on the Management of Confiscated Assets and bilateral protocols with neighboring countries due to lack of available public information. I do not discuss the UN Convention as national law and treaties provide more reliable basis for operational work.
Overview of Course

- We will look at simple examples, breaking them down in MK law, before starting our longer exercises tomorrow.
- I have chosen UK cases and presented them as if they occurred in MK. That way, you can see how it might be handled under MK law.
- We will use for each case the schema to the left.
- You will see the 100 ways in which this ideal case flow doesn’t happen in practice.
- Cases almost always have “tricks” (which test extent to which you apply other law (criminal procedure law, human rights law) – so think before you speak.
- You may refer to the law copies in front of you as you develop your case strategy.

Why torture you will all these exercises?
This is a training of trainers course. This means you must not just learn about asset recovery. You must be fluent enough in its practice to teach others. You represent the highest standard we have in legal education.
The Case of Dechko Dechovich

Case facts

On 15 January 2011, Mr. Dechovich was stopped at Gevgalia border cross point during a routine Customs inspection -- driving a 6 Series BMW (valued at about €80,000). During the search, they found 15,000 euros (in 100 euro notes) in a red sports bag. In the same bag, Customs found several documents with the logo of Makedonski Zeleznici. During questioning, Mr. Dechovich noted that he had been a director at Zelenici years ago and had withdrawn his life savings and subsequently forgot about it in the bag. He was going to Thessaloniki to visit friends and planned on returning in a couple of days.

How to solve the case?

Consider relevant points of law

1. Do the case facts provide the grounds for “reasonable suspicion” as defined under Art. 36 of the Law on the Prevention of Money Laundering?
2. Does it matter if Mr. Dechovich was a public official (for purposes of Art. 21 of the Law on Preventing Corruption)?
3. How does Customs involvement complicate this case? (if at all).

We will give careful consideration of phrases like “property gain gained through a crime” (especially for judges). What are the criteria for art 203a(1) of Criminal Procedure Code for freezing assets?
Let the Law (and lack thereof) Guide Your Analysis

Case facts (stage 2 of our exercise)

The Mak Zeleznici Tovari company received roughly €60,000 (or 15% of its capitalisation) between 2002 and 2007 from the Food Catering Company (in the purchase of securities which were never delivered). During the same time, the Food Catering Company received the contracts for work at Mak Zeleznici. Even cursory analysis of the contracts revealed irregularities in the procurement contracts influenced by Mr. Dechovich (but overseen by a separate panel) which resulted in prices for goods about 65% higher than the market price at the time.

Art. 98 of the Criminal Code stipulates “indirect and direct proceeds of crime that include money… shall be confiscated.”

What are some non-criminal ways?

Look through other law for “levers”

Chapter 15 of Law on Misdeminors

Law on Prevention of Corruption

Law on Money Laundering (various articles)

How Do I Treat the Freeze (and Confiscation)?

You may want to go article-by-article through the law – looking for ways a non-criminal prosecution can achieve similar ends (and judges should look for holes in such an approach).

You don’t teach Asset Recovery, you teach participants to teach themselves
A Checklist as you do your cases

- Everyone familiar with Al Capone strategy
- Use list to the right as way to organise your case
- Point isn't go “Get Detchko” – jurisprudence governing prosecutors office and the Bench
  - human rights first (and equality)
  - rule of law (basis for Asset Recovery)

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<th>Misappropriation of funds</th>
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<td>theft/larceny</td>
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<td>fraud</td>
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<th>Bribery</th>
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<td>bribery</td>
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<td>abuse of functions</td>
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<th>Laundering</th>
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<td>conversion of property</td>
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<td>acquisition of criminal proceeds</td>
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<td>concealment/disguise</td>
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<th>Criminal facilitation</th>
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<td>public procurement breach</td>
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<td>forgery</td>
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<td>complicity</td>
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<td>accounting crimes</td>
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<td>mail/transport crime</td>
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<td>collusion</td>
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<td>customs crime</td>
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<td>obstructing justice</td>
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<tr>
<td>tax crimes</td>
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<tr>
<td>conspiracy</td>
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</table>

In many examples, I will tempt you to proposing something which violates human rights law. Don’t fall for it.

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**Upholding justice has very different constitutional status between UK and MK**
Finding connected persons

British authorities “became aware” of allegations of potential corruption and misappropriation by Joshua Dariye (a foreign public official). Based on this, they conducted a full document search. They caught a link because child attends UK university. From there, easy enough to discover who paid for the education – and where that money can from. Illustrates the Golden Rule – FOLLOW THE MONEY.

Questions:
1. Would MK law enforcement be able to begin search procedures if similar allegations? Public allegations? During case? During request for mutual legal assistance?
2. Would MK courts have standing if no formal request came for MLA?
3. If evidence of misappropriate comes (but no request by Nigerian authorities), can MK freeze and seize?
4. Who is the victim of this crime (for purposes of restitution? “the people” is too vague)

Source: Brun et al. (2011).
Mining Information for Connections

- Looking at electricity usage can signal extra residents
- Other sources of information (which require court order to release)
- New realm of blogosphere doesn’t need court order (and often more illuminating)
- We cover international info. later

Two questions for training
1. What legal test guides standard of suspicion required to order release of information from Public Revenue Office?
2. If likely recovery equals €60,000, how many man-days should be allocated to the case?

Objective is to find money and connections – not proof of wrongdoing
In Rem Judgments in a Civil Law Context

- Corruption usually involves nexus of crimes
  - bribery
  - money laundering
  - concealment
  - accounting fraud
  - complicity
  - conspiracy (almost by definition!)
- Strategy is to “divide and conquer”
- Use lower burden of proof for delicts (civil) offences (where allowed)
- Judgments against property

Macedonian law
Art. 100(a)(1) of CC – allows confiscation for objects used (or be used) to commit a crime
Art. 203(1) of CPC – allows confiscation for “evidence” (are proceeds of crime or unexplained wealth “evidence”?)
Art 100(a)4 – non-conviction based confiscation

Art 203c(1) – exception for state secrets (leaves hole as we saw in UK context).

We will see how/if article 36 of Corruption Prevention Law de facto in rem?
Breaking Link between Crime and Criminal Proceeds

Case facts
In April 2009, over 27 toll booth operators had been arrested in a large-scale collusion to defraud the public toll company out of €5.5 million in tolls. The collusion extended to toll collector, their supervisors, and a local political party (which used the proceeds to fund several candidate trips). The investigation started when a citizen noticed that one receipt (which he was giving to his company’s accounting department for reimbursement) looked slightly different than the others. To avoid suspicion on himself, he reported the receipt to the company headquarters for a replacement – who then informed the police.

Legal principle for judges
1. Is an unusually printed receipt enough evidence to issue a search warrant?
   What principle are you relying on (not just what seems right).
2. What exactly is listed on the search warrant?
3. What principle for establishing time for holding assets on suspicion of crime?
Intermezzo: Learning Black Letter Law through Use

Case facts
Vlado Mansky, an official in the Bitola mayor’s office, has been accused by a whistleblower of receiving a pension while still drawing his official salary. The whistleblower has walked into the police station of his own accord, claiming to be an employee of Sparkasse (where both salaries get paid into). In addition, he claims the Mr. Mansky came to the branch late the night before to withdraw €95,000 and the suggested he was leaving the country for an “indeterminate amount of time.” The accuser notes in his account to police that Mr. Mansky also received transfers into his account from an alleged front company controlled by the Demokratski sojuz Party. The accuser has come because he was afraid of being found guilty of helping Mr. Mansky and saw in a Hollywood movie that if he comes to the police, they can guarantee he won’t be prosecuted.

Instructions:
Go through each stage of the freezing and confiscation proceedings – making a special point to cite the relevant article in Macedonian law. Repetition is the mother of learning. As you look up the article numbers, this will help you to remember them during your daily work. You will also see what exceptions are in place. Don’t worry about citing the non corruption, laundering, non-confiscation parts of the case.

Hints: Asset declaration    Rules of freezing assets    Rules for confiscation    Breach of Confidentiality Rights under MK law    How to handle Sparkasse    How to handle the political side    Don’t forget about the whistleblower

Remember – the goal is to cite black letter law, don’t let the complexity of the case throw you
Special considerations for search and seizure

Case facts

From the Wall Street Journal -- “Stern Hu, an executive at the British-Australian mining giant Rio Tinto, has said in court that he accepted two large bribes in late 2008 and early 2009 totaling about $1 million from Chinese steel mills in exchange for agreeing to sell them long-term supplies of Iron ore”

The search warrant for the related parties should include parts related to Hu (and associates), but not so much that judge refuses to issue. Used to thinking about LIKELY GUILT. RISK PARADIGM often determines extent of search and seizure.

Will parties (like Pan-Asian Minerals) destroy evidence?
Risk that third-parties will dissipate assets.

Risk = probability of guilt * probability of obstruction justice – prob of corroborating evidence

Best practice calls for swooping in and seizing as much evidence and financial documents as possible. Such a practice is less clear for third-parties in light of their civil rights.

Article 98 and 98a provides for “extended confiscation” (confiscation from third-parties). The article makes provision for confiscation when the value received does not correspond with the value given. (Any difference is an obvious risk indicator)

For the full article, read online.
An Obvious Remedy for Recoveries

Case facts

In 2009, Piotr Stayatski took over €700,000 in bribes as a sitting member of a procurement commission in the Ministry of Education. He was a member of the majority political party at the time. Public outcry caused him to resign – with no apparent investigation to follow up. If this happened in Macedonia, how might prosecution might find a way to prosecute him for related offenses without a politically difficult prosecution?

The bribery offense – which we assume for the purposes of this exercise can not be prosecuted for lack of evidence or because of political pressure which could jeopardise the wider anti-corruption prosecutorial strategy.

Look at Piotr’s asset declaration – allowed under Article 36 of the Law on Corruption Prevention - and compare with existing assets (which will be larger).

Press for recovery of taxes on excess income – allowed under Article 36(4) of the Law on Corruption Prevention.

Case exercise

1. Is the strategy presented above the best way to deal with this case – why or why not?
   Please use the material we already discussed in your answer.

2. Does the res judicata principle apply in this case if the prosecutor decides later to follow up on the unpunishable part of the case? Is it always true that all unexplained wealth can be taxed?
Every structure can be traced by “backflows”

Flow charts and network graphs (shown to the right) are the basic tools for investigators and prosecutors when any recovery possible. Judges would also be familiar with them as these cases require their careful (and skeptical) evaluation of the relationships which often guide the investigation.

Wire request design must have counterparty communications in various destinations

Corrupt payments will have invoices and other accounting artifacts created to legitimise the bribe payment. Look for invoice flow…

Invoices can “shadow” the flow of corrupt payments – cycling back in the opposite direction as cash. Look for unusual items, excessive costs, or other indicators (see next slide)

Always backward flow from money – look for these back-flows
Corruption auditing for the non-auditor

- Very high prices (of course)
- Invoices without contracts
- Vague contracts for services or performance bonuses
- Back-dated contracts
- No background docs on the supplier
- Unusual contract addenda
- Excessive bad debt write-offs
- Informal procedures

- Payment requests to tax havens
- Hand-delivery of payments
- Order/payment smurfing (or spreading single payment across multiple accounts of a single payee)
- Cash payments (always high risk)
- Missing delivery/receipt paperwork
- Unrelated third-parties as payees, recipients, etc.

In a 2007 case, IKEA’s internal controls picked up invoice discrepancies – leading to referral to the SFO.

Generalised audit software so easy to use now that anyone can use

Sources: Brun et al. (2011), SFO, and Ernst & Young.
Pre-restraint planning and managing assets

Think of asset as flow of incomes and expenses. You can “break” each bit apart, and put liens on bits so as not to harm innocent third-parties.

You want to maximise value of the asset (or minimise harm) if innocent third-parties involved. So, you need to know which assets to freeze, which to confiscate,

You want to “lock-in” assets so they can’t be dissipated through liens (printing directly on loans for example that they can’t be resold).

Practice Based on Case

In 2009, Robert Slavko had invested over €750,000 in his wife’s dress making business. The business at the time Robert received notice he was under investigation for corruption (for receiving over €1 million in bribes), had revenues of almost €3 million per year. Investigators (as of today) have no reason to suspect that his wife – nor the 24 employees of Slavko Beauty Fashions Ltd. – had any knowledge (or participation in) Robert’s corruption. His contribution amounted to roughly 40% of the firm’s capitalisation.

What should investigators seek to freeze? To confiscate?

Extra credit: The wife is willing to snitch on her husband if he can keep the business.

US checklist for managing assets

“If its dead, grab it. If it breathes, hold it down and milk it.”
Comingling (Article 97a)

Comingled assets
Article 97a of CC clearly and expressly sets up a proceeds + benefits model of restitution.

97a(1) – converted proceeds sold at full value (if 100% financed)
97a(2) – seizure up to value of criminal proceeds
97a(3) – seizure of fruits of criminal proceeds

Fruit of the poisonous tree?
As I read MK law, no provision to take fruit deriving from criminal proceeds.
An example, bribe taker buys $1m of Apple Inc. shares in 2009. By 2011, worth $4m. My reading is that confiscate $1m. “Standard” view is that all $4m should be confiscated so that “crime doesn’t pay”.
A Second Look at NCB Confiscation

**Property based confiscation (Art. 97)**

This is the easy one – just “trace” the money (and give it back).

- Vladimir collects $200,000 in bribes.
- The $200,000 is “neatly” converted into real property.
- At conviction, real property taken, sold and proceeds used to compensate victim.

**Value-based confiscation (Art. 96m(2))**

This is the tough one – requires use of economic methods to value harm.

- We use the example of Toshe because easy example to understand (and emotional of Macedonians).
- The value of harm done to Toshe include:
  a) lost revenue from singing career
  b) expense at accident and death
  c) potential emotional distress of family, etc.

Economic valuation of economic crime uses same principles. We must take discounted value of potential earnings, opportunity cost, and other factors.

NCB means non-conviction-based (prosecution)
An Example of a “Mixed” Judgment

The Case Example

According to the BBC, “the UK arm of a US chemicals firm has been fined $12.7m (£8.5m) after admitting bribing Indonesian officials. Innospec paid bribes of more than $8.5m to prolong the use of harmful, lead-based fuel in petrol engine cars.” Why did the judge choose $12.7 million? Why note $13m? Why not $50 million?

The actual bribes paid to Indonesian officials represent a harm to Innospec’s shareholders.

The Indonesians using these products will have shorter lives (valued at lost wages PLUS medical bills).

Any gains (interest, operating profits) arising from the use of revenues from tainted products

Don’t kill the company – so can continue payments (optimal choking point).

Actual amount based on “plea bargain” between UK and US authorities – showing on-going political nature of these settlements.

As this example, awarding damages is never as simple as it seems in the instruction manuals and legislation. Understanding the deeper economic and political forces determining the “equilibrium” payment can help determine more equitable judgments (and more incentive-compatible prosecutorial petitions).

Read the full story online.
Partial Administrative Recovery

**Case facts**

On 15 January 2011, Mr. Dechovich was stopped at Gevgalia border cross point during a routine Customs inspection driving a 6 Series BMW (valued at about €80,000). During the search, they found 15,000 euros (in 100 euro notes) in a red sports bag. In the same bag, Customs found several documents with the logo of Makedonski Zeleznici. During questioning, Mr. Dechovich noted that he had been a director at Zelenici and had withdrawn his life savings and subsequently forgot about it in the bag. He was going to Thessaloniki to visit friends and planned on returning in a couple of days.

**Violations**

Article 27 (Cooling off period)
Article 28 (conflict of interest in shareholding – if held regulatory role)
Article 32 (misuse of public procurement)
(possible breaches of article 33 and 34 about changes in assets)

**Fines in Prevention Corruption Law**
€320-€770 in fines for natural persons
€3,075 – €4,600 for legal persons

Strategy aims to replace damages by easier to collect fines

*Not a lot – but is about 30% of the value in sports bag*
Victim Recoveries

**Article 99 of CC**

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<th>6 months</th>
<th>3 months</th>
<th>3 months</th>
<th>2 years since decision</th>
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</thead>
<tbody>
<tr>
<td>Criminal trial determining claim starts</td>
<td>Judgment passed and victims can claim damages</td>
<td>Victims finds out about judgment</td>
<td>last date to sue for damages</td>
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</tbody>
</table>

- In 2007 the federal government of Nigeria won a series of civil asset recovery cases against Alamieyeseigha and Dariye at the High Court in London.
- Macmillan ordered by SFO to pay $17m for corruption in South Sudan.
- General principle in international law that damages awarded put the victim in the same position as would have been if corruption did not occur.

**Case question**
The SFO ordered Macmillan to pay $17 million for damages in South Sudan. According to the material in these slides, what likely determined the SFO’s request for this sum? Why not $18 million? Or $100 million?
1. **Article 36(1) of Law on ML** – in case of reasonable suspicion...the Office shall [ask the prosecutor to stop the suspicious transaction].
2. **Article 39(1) of Law on ML** – the investigative judge shall, within 24 hours from the receipt [decide to issue order to terminate transaction, seize money, etc.]

**How suspicious is suspicious enough?**

Risk = probability of wrong doing * value at risk

**Case exercise**

1. Would a MK judge accept to issue a freezing order based on the FIU report above?
   Please refer to principle from MK jurisprudence and material from this course.
2. Is it in the public interest to proceed with investigation of
3. How would you deal with the bank’s negligence (if any)?
Inermezzo: Learning Black Letter Law through Group Use

Questions:

1. What is time limit (in various articles) a judge can maintain a freezing order on an account?
   
   Hint: don’t just look for time limits, think about the desired effects of freezing assets.

2. A politician has taken bribes every year between 2005 and 2009. Should he be prosecuted?
   
   Hint: think about statute of limitations, costs and the way we have been talking about risk.

3. A senior MK politician has used the proceeds of corruption to send his children to the LSE in the UK. Should the funds supporting his children’s education be confiscated? If so, how?
   
   Hint: This requires a critical reading of the law, and a think about the rights of innocent third-parties. Don’t worry about international elements which we will address in the latter part of the day.
A First Look at International Co-operation

In 2009, Piotr Stayatski took over €700,000 in bribes as a sitting member of a procurement commission in the Ministry of Education. Investigators suspect that he has used part of these proceeds to fund partial participation in the *Happy Times* restaurant chain in Bulgaria. To that end, the lead investigator has picked up the phone and called a colleague working for the Bulgarian prosecutors office he met at a conference in Sofia. The investigator's partner informs him that any evidence he collects will not be allowed at trail because such a contact has been made illegally. Is he right?

**Case facts**

ETS 198 Article 15(1)
Parties (that’s you) shall mutually co-operate with each other to the widest extent possible

ETS 198 Article 15(3)
Follow the counterparty’s law

ETS 198 Article 15(4)
MK requests abroad have same priority as internally generated requests (and visa-versa)

ETS 198 Article 16
Parties must give “the widest possible measure of assistance” in freezing and confiscating proceeds of crime.

ETS 198 Article 20
Can send information to another Party of own accord.

**Macedonia’s law seems to give direct effect to international conventions**

1. 100a(6) of CC – return assets “Under the conditions stipulated in the ratified international agreements”

2. Art 203b of CPC – securing of assets subject to “international agreements ratified.”

You will find copies of ETS198 and 182 in your folders.
Resources during investigation/prosecution

- Former networks can prevent procedural violations (by trying to find info yourself)
- Good practice to start intl bit as soon as possible

Division of labour between bank side (which FIU’s are equipped to do) and case work (which investigators do).
Drafting the MLA request

- Go step-by-step – use several separate requests rather one mega-request
- More detail helps ensure foreign cooperation
- **Flip on head:** MK Judge should demand these details to ensure substantive/procedural rights

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<th>MLA Request</th>
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<td><strong>Legal basis:</strong></td>
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<td><strong>Nature of Matter:</strong></td>
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<td><strong>Purpose of Request:</strong></td>
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<td><strong>Case Facts:</strong></td>
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<td><strong>Assistance wanted:</strong></td>
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<td><strong>Confidentiality:</strong></td>
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<td><strong>Execution period:</strong></td>
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<td><strong>Assurances:</strong></td>
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<tr>
<td><strong>Prior cases/other attempts:</strong></td>
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<td><strong>Contact info:</strong></td>
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More detail is better than less
Flogging off Cases on Richer Countries

- **OECD Convention**
  - People from these countries commit offence in own country if they bribe in MK
  - Bribery of foreign officials (that’s you – and all public officials)
  - Enforceable anywhere in OECD

- **FCPA**
  - If they have any “touch” in USA, Feds bust them rambo style
  - Difficult to avoid one of three legs of US jurisdiction

- **UK 2010 Anti-Bribery Act**
  - Failing to prevent (corporate negligence)
  - UK courts interventionist in corruption cases abroad lately
  - Bribery through intermediaries punishable
  - Liability for accountants and lawyers

*Many developing countries may wish to extradict instead of prosecute*
Handling multiple jurisdictions

Case facts

In 2009, a senior Macedonian Telecom executive informs you that Rudy Underman – a senior director at Czech Telephone and Telegraph (CTT) – approached them with an offer. The offer – accept €5 million in contracts for unspecified work in exchange for not competing on several government procurements and contracts for telecoms goods and services. The informant has testified his CTT colleague mentioned that several Macedonian officials have accepted bribes while abroad on study tours (paid for by EU funding) in the UK, France, and Germany.

- **Jurisdiction harmed – not necessarily where harms occurred**
- **Choice of forum**
  - Prosecutor – chose the “best” in terms of risks and returns
  - Judges – standard material from your intl law courses
- **Slice the case up – UK very good at civil recovery for example.**

Case exercise

1. Does Article 19 of the Law on Preventing Corruption apply? How would the article be implemented in practice (if it applies)?
2. Are the MK officials who took bribes prosecutable in MK or in EU?
3. How to deal with the hearsay element of the case?
4. What are the steps to arranging the investigation of this case? (if it is investigatable?)
Case Exercise: Calculating MK’s involvement

Case facts

In 2009, a senior Macedonian Telecom executive informs you that Rudy Underman – a senior director at Czech Telephone and Telegraph (CTT) – approached them with an offer. These bribes to MK officials totalled €6,000. A report conducted by Deloitte (paid for by CTT and confirmed as sound by 3 MK experts) shows that the bribes’ likely effect was welfare improving for the average Macedonian telephone services consumer.

Please use ETS 182 to help with your answers.

- Likely recoveries in MK?
- Cost of conducting the investigation in MK
- Cost out scenario of foreign lead and claim damages
- How much are damages?
- What expenses are reimburseable?

You need to worry about this because if MK wants to recover assets from abroad – must often give exact amount to foreign authorities. The earlier, the better.

Extra credit: Is there a competition law element to the case? (No, but not for the reason you think)
Avoiding Pitfalls in MLA requests

On 15 January 2011, Mr. Dechovich was stopped at Gevgalia border cross point during a routine Customs inspection driving a 6 Series BMW (valued at about €80,000). During the search, they found 15,000 euros (in 100 euro notes) in a red sports bag. In the same bag, Customs found several documents with the logo of Makedonski Zeleznici. During questioning, Mr. Dechovich noted that he had been a director at Zelenici and had withdrawn his life savings and subsequently forgot about it in the bag. He was going to Thessaloniki to visit friends and planned on returning in a couple of days.

The next day, the investigator in charge requested a court order to obtain information on all Mr. Dechovich’s Macedonia and foreign bank accounts. Investigators decided to collect information on Mr. Dechovich’s MK financial status first, then tackle the foreign elements of the case (hint: think about MK’s ex parte rules). They think if they can get a MK incitement – they might be able to send it over for foreign enforcement. They also requested a search warrant for Mr. Dechovich’s home to look for cash and other valuables potentially involved in corruption.

They would also like to ask Thessaloniki police to confirm that Mr. Dechovich has friends in the city – and would like to send a request by email to ask them to visit the address given by Mr. Dechovich in order to ask them questions about their involvement with Mr. Dechovich. The Greek element of the case adds a special dimension to the case – as Greek banks may claim bank secrecy. In general, because all requests must go through the Ministry of Foreign Affairs (or diplomatic channels), pursuing such a case is practically impossible.

Can you find 6 possible problems with the way investigators pursued the case?
The Rest of the Course

- We have done little case studies to start you thinking about issues (and how to teach them)
- We will look at
  - 4 extended cases
  - 4 special topics
  - time for one-to-one tutorials / mentoring
- We will work on adopting these slides (and others in course) for your own courses.

This is Training of Trainers: So Teaching you to Teach
Financial and Statistics Practical

Bryane Michael, U. of Hong Kong

Disclaimer: All information on these slides is based on public information. No case or confidential information has been used on these slides. Examples have been taken from other countries (mostly UK) and similarity with actual cases is purely coincidental. This presentation contains graphics from the Internet provided under fair use laws.
Lecture Outline

- Financial Statements Overview
- Basic Statistics Overview
- The law and practice of statistics in identifying corruption on the macro-scale
- Law and practice of using statistics for ML on large scale
- Practice Exercises
Basics of Financial Reporting

**Income statement:**
like video... tells what is coming in and out over a period

**Balance Sheet:**
like video... tells what is coming in and out over a period

**Main Ledger**

**In this case, change and then unchange is suspicious**

**Income Statement Shows the Rates of Change of the Balance Sheet**

**General rule:** Anything that's not like anything else is suspicious
Practice Questions

Practice questions (done in lecture)
1. Mr. Malcho is supervising an employee. He agrees to increase his salary and sends the decision to payroll so they can increase his salary.
2. It has been a great year, sales increased by 70% while the economy grew by only 15%.
3. Mr. Malcho claims that he delivered $10,000 to a customer who came by. How can we check if that is true?

Four iron principles of business finance
1. Changes (or lack of changes) in levels and rates of change signal risk
2. Separation of recording, decision making and cash disbursement
3. Every paper given away gets a paper in return (double-entry)
4. In the digital, nothing disappears without a trace (I mean nothing!).

Questions for group work
1. The manager of the local Beko distributor has sold a new washing machine and agreed that the customer can receive store credit. Is there any problem with this?
2. One audited company noted that – to increase the accountability of each purchasing manager – they have made each one responsible for invoicing, receiving bills, and pruchase orders. Does this increase accountability?
### Reading an income statement

**THE COCA-COLA COMPANY AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF INCOME**

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>NET OPERATING REVENUES</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$35,119</td>
<td>$30,990</td>
<td>$31,944</td>
</tr>
<tr>
<td><strong>GROSS PROFIT</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling, general and administrative expenses</td>
<td>12,693</td>
<td>11,088</td>
<td>11,374</td>
</tr>
<tr>
<td><strong>OPERATING INCOME</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>22,426</td>
<td>19,902</td>
<td>20,570</td>
</tr>
<tr>
<td>Interest expense</td>
<td>13,458</td>
<td>11,358</td>
<td>11,774</td>
</tr>
<tr>
<td>Equity income (loss) — net</td>
<td>819</td>
<td>313</td>
<td>350</td>
</tr>
<tr>
<td><strong>INCOME BEFORE INCOME TAXES</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income taxes</td>
<td>8,449</td>
<td>8,231</td>
<td>8,446</td>
</tr>
<tr>
<td><strong>CONSOLIDATED NET INCOME</strong></td>
<td>317</td>
<td>249</td>
<td>333</td>
</tr>
<tr>
<td>Less: Net income attributable to noncontrolling interests</td>
<td>733</td>
<td>355</td>
<td>438</td>
</tr>
<tr>
<td><strong>NET INCOME ATTRIBUTABLE TO SHAREOWNERS OF THE COCA-COLA COMPANY</strong></td>
<td>1,025</td>
<td>781</td>
<td>(874)</td>
</tr>
<tr>
<td></td>
<td>5,185</td>
<td>40</td>
<td>39</td>
</tr>
<tr>
<td><strong>Ratios</strong></td>
<td>2.76</td>
<td>13.3%</td>
<td></td>
</tr>
<tr>
<td><strong>Change</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>14,243</td>
<td>8,946</td>
<td>7,506</td>
</tr>
<tr>
<td></td>
<td>2,384</td>
<td>2,040</td>
<td>1,632</td>
</tr>
<tr>
<td></td>
<td>11,859</td>
<td>6,906</td>
<td>5,874</td>
</tr>
<tr>
<td></td>
<td>50</td>
<td>82</td>
<td>67</td>
</tr>
<tr>
<td><strong>$ 11,809</strong></td>
<td>$ 6,824</td>
<td>$ 5,807</td>
<td></td>
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Relations between data tell much more than simply looking at data

Judges should be suspicious and compute these numbers for themselves.
A first look at standard deviations

Financial Data often have an Average (Mean) which suggests what

Very low valued transactions just as suspicious. Either not recording full value of goods/services getting, or under-valuing payments.

Usual transactions suggest mis-appropriation. On the expense side, someone is trying to get money out. On revenue side, someone is getting money in.

How to know if a payment is suspicious?

The standard deviation of a group of data tell us. Just put the data into Excel- it will tell you the standard deviation. Any values which are more than 2 standard deviations are suspicious.

Statistics like these help us recover assets in three ways. First, they signal when assets leave a person or company. Second, they signal when they arrive somewhere. Third, the relationships between data tell us something isn't right.

Every asset casts a shadow on other financial information.

Useful for “balance of probabilities” because tells something improbable
Statistical Confidence and the Balance of Probabilities

Statistics can tell how likely (or unlikely) a financial transaction is likely to have occurred under the conditions a suspect (or target of an administrative procedure) claims. We will see this on the next slide…

We can be 97.5% confident that Vlado (with 80k in assets) did not earn them like his colleagues.

Excel will give you this probability.*

* Caveat – the statistical power of a test like this to determine the probability of a particular observation being more than 95% likely different than the population mean depends on the “power” of the test (power is a term in statistics with its own mathematical definition). Before stripping a man of his life savings based on an Excel calculation, it is jolly good to check with a mathematician to make sure you are interpreting these data correctly.
Repetition is the Mother of Learning

“We reject the null hypothesis that Vlado belongs to the sample of civil servants which accurately declared their assets at the 95% level of probability”

Means it is highly unlikely Vlado could be following the same rules as the others.

P<5% is the convention used among social sciences to determine if something is believable or not.

P<5% is much more stringent than “reasonable belief” (and more objectively verifiable as well).

Practice Questions
1. The owner of Mak-Fruckovi has more assets than two standard deviations more than his peers in similar sized companies. His explanation of these assets is that he sold advice to a foreign company with a handshake (no papers). These assets consist of a Porsche and shares in US companies (and his ownership suddenly appeared on Fortune magazine’s website). No suspicion of criminality exists (yet).
2. Assume his assets were 1.5 standard deviations (so the probability that he got them the same the other company executives got them is less than 30%). Is an in rem judgment possible? Wise?
3. What is the Power distribution and why is a better way to judge unexplained wealth and income?
We can’t just take all wealth that can’t be explained. It doesn’t allow for explainable unexplainables. In other words, everyone will have some unexplainable wealth. But some individuals will have much more unexplainable wealth than others. How much unexplainable wealth is really too much?

“Reasonable suspicion” enough to issue search warrant? “Reasonable suspicion” enough to freeze assets? “Reasonable suspicion” enough to begin confiscation?

Each level of suspicion requires increasing higher burden of proof (and rebuttable resumption?). Remember your legal PRINCIPLES – especially what you learned about RISK.

Does use of statistics to ferret out criminals violate presumption of innocence?
Using statistics in detection, case construction and prosecution of a case

Account 1

unrelated

Account 2

unrelated

Account 3

unrelated

unrelated

unrelated

unrelated

unrelated

unrelated

unrelated

Account A

unrelated

Account B

unrelated

Account C

Positive correlation – means money going into related accounts
Negative correlation – means one group of accounts used to fund another group
Multiple regression and clustering analysis are two tools for ID.

Understanding rho – between 1 and -1.
Practice Questions

Finding Illicit Wealth
1. Statistical analysis reveals two groups of accounts in the meat processing sector. One group of accounts, centered around Mysa MK has a correlation coefficient of 0.72. Another group with Gavad-MK has a correlation coefficient of -0.55. Upon looking at individual transactions, you see that similar transaction amounts from the first group into the second group. The brief you read highlights about 40 transactions – all of which are less than $450. What non-business explanations might exist?
2. Has the FIU acted appropriately to flag these clusters of transactions (under MK law?)
3. Does Prosecution ask for a search warrant?
4. Does Justice grant the request?

Dealing with Unexplained Wealth
1. You trace the above noted money to a set of payments made for meat products. You can find purchase orders for the meat in question, but no records of meat deliveries. The general manager notes that the meat was going rotten and was delivered quickly without paper work.
2. What does Prosecution do?
3. What will Defence say? What would be the likely judgment?
During questioning, a suspect indicates that he receives a large part of his income from relatives in Germany. We can not know for sure (as there is no trail and his relatives will agree to protect their family member). However, we can rely on statistical averages to indicate if we have a reasonable suspicion about his claim.

In the reconstructed graph to the right, we show the average MULTIPLE regression analysis for MK individuals receiving family payments from DE. Our individual is the “outlier”.

**Questions**
1. The suspect in question – after being confronted with the data above – noted that he mis-remembered where he got his income. He noted that he sold advice 7 years ago only recently received payment. What is the prosecutors’ best strategy dealing with testimony “story” changes caused by data?
2. The suspect has questioned the methodology used in compiling these data – and has indicated at trial that he has a right to a detailed recreation of how these data have been reconstructed. Preparing such a recreation will cost more than the likely recovery. No predicate crime has been found (though the request may give prosecutors more time to look. Does the time gain offset the expense? What are the legal principles involved?
What every judge should know about statistics

- The P-value of a test
- correlation
- regression
- when p-test fails
- 5 problems of correlation
- 5 lies of regression

Beyond reasonable doubt
by Helen Joyce

Two children die of suffication while sleeping
This statistic of 1 in 73 million of natural occurrences
Are Clarks guilty?
What if they had banking relations with same prob.?
Intermission

In the morning session, we went through the case *Prosecuting the Case of the $1 million Deposit*. In that case, we looked at substantive and procedural points of law. So far, we have looked at methods of financial analysis and statistics needed to detect financial crime. In this intermission, we will look at prosecutorial strategy related to the $1 million deposit case. Try to think about your new knowledge of financial analysis and statistics would have changed the prosecutorial decisions and judgments make during our case analysis. As you see, there is no right or wrong – only better or worse.

Keyboard cat is a tool used to break up tragic or serious elements of an show. This intermission aims to take a similar break – by stepping back and looking at the broader principles behind your work.

Questions

1. How would you work with investigators to develop a programme of statistical analysis aimed at maximising the likelihood of “sanctioning”
2. How would that programme differ from one aimed at maximising revenue to the Government and/or victims?
3. We talked about how each Macedonian institution deals with the investigation and restitution of assets differently. How would each institution design their financial/statistical tests differently?
Combining Financial and Statistical Analysis

Financial statements to check
1. Company B’s bank deposit journal
2. Company’s expense journal (cash not going from Director back to company)
3. Short time lag between sales from Company A to bank deposits.

Aggregates across companies can often tell more than per company
“consideration” \[\text{€ (cash)}\]

[Diagram]

Financial statements to check
1. Law firm’s receivables from companies
2. Time to completion and payment (using Accounts Receivables ledgers).
3. Timing, size and frequency of payments for services to law firm

Questions
1. What concentration ratio needed in lawyer’s client base before investigation (don’t worry about specifics, I’m looking for principles you use to answer question).
2. Is it possible to prosecute a “flow” as assets (like we have been discussing in these last two slides) rather than a stock (like we discussed in the first day)?
3. How might we design and evaluate (from a legal point of view) a statistical test which measures the relationship between Company’s contracts and the flow of “consideration” to the public official?

The Law of One Price (pardon the pun)

Over-invoicing provides a nice way to transfer resources to friends. But how to establish a legally defensible definition of over-invoicing. Prices can vary enormously between suppliers, times and so forth. Such variation means that judging over-invoicing is like judging pornography (you know it when you see it). But there is another way…

Statistics provides an objective means of determining the exact likelihood that some invoicing behaviours differ from "normal." In this example, we show a Motorola invoice price roughly 3 standard deviations away from the mean. That means this payer MUST have transferred illicit wealth (because the invoicer could not find a supplier as expensive as him/her).

Such evidence obviously provides a sufficient basis for the issue of a search warrant. However, would such evidence --- taken alone – provide sufficient grounds for a freezing order?
Prosecuting without access to tax haven data

These cases involve transfer into a black box, coming from a black box or taken from a black box. We can now use data to “triangulate” where payments go in and come out (as these places normally generate income). You don’t need to do the complicated analysis. But you do need to know what constitutes grounds for potential prosecution under the laws we already reviewed. Judges need to know what kind of evidence and arguments are admissible.

Questions
1. Vlado (again) receives a $5 million wire from Afghanistan. He notes that the wire comes as a charitable donation to him from a rich industrialist who heard about him. Does this constitute sufficient grounds under MK law to begin confiscation proceedings?
2. In defence of a $2.5m wire from the UAE, a defendant presents an invoice for work and an signed statement from a business partner. Is this evidence admissible in an MK court?
3. A statistical analysis of the possible placement and layering stages of a financial crime indicate a 99.5% probability that the placement transactions did not come from the sources claimed by the defendant. Placement occurred in Uruguay. How should prosecution proceed?
Ghost workers provide one of the most popular and easiest ways to smuggle funds out of the company (and into the bank accounts of parties affiliated with the corrupt civil servant or politician). Ghosts can also quickly disappear – making unannounced investigations particularly important. Even if found, they can refuse to disclose who they give payments to. In these situations, statistics can play a key role in the prosecutor’s arsenal.

**Questions:**
1. The most damning evidence you are able to collect on a case turns out to be an almost perfect correlation between payments made to a ghost-worker who meets regularly with a public official. Does this correlation provide sufficient grounds for Prosecution to go ahead with the case? What non-conviction-based remedies might be used in this circumstance?
2. What is Prosecution’s stance toward the company? (only for the ghost workers)?
3. What is Prosecution’s strategy for conducting the investigation against the Company?
Practicing to see Relations in Financial Statements

Look for relations in the data – it's both prosecutors and judges' job.
Use the file you have each been given

Identify the suspicious payments

Can you tell a story based on the profile of these payments?

Unusual transactions and parties
- Entrepreneur demonstrates poor knowledge about their business
- Transaction in goods or services not fitting company’s profile
- Transaction without an evident commercial basis
- Transaction or agreements without relevant supporting documents
- Transactions with offshore companies
- Transaction with suspected criminals or their partners
- Non-transparent / non-identifiable customers, creditors or lenders
- Transactions with business associates or customers that share a common address
- Transactions identified as asset sales but assets cannot be substantiated

Unusual money flows
- Payments to or from third parties who are not involved in the transaction
- Payments to or from unrelated offshore companies or accounts
- Company bank account used as a cash flow-through account
- Non-transparent or non-verifiable origin of the money
- Denominations and currency not the norm in the industry
- Bank deposits not declared as turnover (sales)
- Money flows without apparent economic reason or supporting documentation
- Unusual use of credit cards or debt instruments

Unusual turnover/sales
- Significant increase in (anonymous) cash turnover/sales (see Examples below)
- Large cash payments received for luxury goods sold
- Large cash payments received for goods never delivered (fictional buyer)
- Transactions without an evident commercial basis or supporting documentation on file
- Transactions and agreements without related costs or relevant supporting documentation
- Transactions with suspected criminals or their partners
- Transactions in goods or services not fitting company’s profile
- General description on invoices relating to large cost items
- Cost of sales invoiced by non-transparent corporations
- Profit sharing agreements with no relevant economic base
- Lack of relevant supporting documentation
- Costs made not leading to turnover/sales

What you have learned

- Identify suspicious transactions, income and wealth
- Decide criterion – based on MK law – for prosecutors and judges
- Tie each stage of the recovery to skills in financial and statistical analysis
- Plan country-wide programmes based on “delaying” and “disintegration”

<table>
<thead>
<tr>
<th>Prosecutors criteria</th>
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</thead>
<tbody>
<tr>
<td>1. proceeding with prosecution</td>
</tr>
<tr>
<td>2. prosecutorial strategy</td>
</tr>
<tr>
<td>3. criteria based on “probable” defined by probability, risk, and public interest</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Judges criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. criteria for issuing warrants and writs</td>
</tr>
<tr>
<td>2. deciding on admissibility</td>
</tr>
<tr>
<td>3. looking for missing arguments and evidence in trial</td>
</tr>
</tbody>
</table>

We continue to use these skills in our cases – so it’s not learn and forget