

Legal Sector Affinity Group (LSAG) – Advisory Notice Chinese underground banking and funds from China

This notice is supplementary to the main LSAG guidance and does not supersede it. It is not for your supervisor to provide specific legal advice and/or confirmation on the application of the money laundering regulations (MLRs). You must satisfy yourself that you have complied with your legal/regulatory obligations under the MLRs, taking into account the information we provide.

While care has been taken to make sure that this advisory notice is accurate, up to date and useful, members of the LSAG will not accept any legal liability in relation to this advisory note (which is not HM Treasury approved).

Background

There may be situations where your firm is asked to undertake a transaction where the client's money has come from abroad. In some cases, this funding might have entered the legitimate economy through informal value transfer systems (IVTS) that do not use the normal banking system and/or have not complied with national currency controls. This is a particular issue in relation to [funds coming from China](#).

This guidance explores the key risks arising from the legal and illegal use of IVTS in the Chinese context, along with the circumvention of Chinese foreign currency controls. It also provides practical measures to help you mitigate these risks.

Transfers of funds from China

Under Chinese law, domestic entities and individuals¹ are permitted to take funds out of China only for certain limited purposes such as training, study, travel or family support. There is also usually a US\$50,000 limit on such transfers. This limit applies per person, per year.

Moving funds for other purposes may be prohibited by the Chinese government. Buying real property overseas for the purposes of investment, for example, is strictly prohibited unless the individual is leaving the country permanently. Consequently, people may seek to circumvent these prohibitions by making a false declaration to the Chinese government about the purpose of the transfer.

Methods of bypassing currency controls

Clients receiving money from individuals or businesses that you cannot verify can be a red flag of money laundering. It could also be a sign that money is being sent using unofficial sources to evade currency controls. Unofficial sources can include unregulated financial entities but can also include illegal shadow banking networks.

¹ Defined under [Article 52 of the Regulations of the People's Republic of China on Foreign Exchange Administration](#) as follows:

"Domestic entities" refers to State organs, enterprises, institutions, public organizations, or the armed forces, etc. within the territory of the People's Republic of China, excluding foreign diplomatic and consular agencies in China and representative offices of international organizations in China.

"Domestic individuals" refers to Chinese citizens, or foreign nationals who have continuously lived in the People's Republic of China for more than one year, excluding foreign diplomats in China and resident representatives of international organizations in China.

Splitting

This involves breaking up a transaction into smaller transactions at or below the \$50,000 limit, often via friends or family members, which are then recombined in an account outside China. It is explicitly banned under Chinese law.

This does not in itself render the monies to be the proceeds of crime. It does however make it harder to establish the source of funds, as doing so requires checking all the parties involved in splitting the funds.

Chinese underground banking and underground currency exchange

Money can also be moved outside of the banking system using IVTS. IVTS are a long-standing and often integral part of the economic framework and systems of many cultures, including China. They often involve a complex network of transactions which may also involve conventional banking. In most cases, the use of such systems is for entirely legitimate purposes, although to operate legally in the UK such systems must be appropriately registered with the FCA. What must be taken into consideration is that in IVTS value, rather than monies are what moves. So monies entering the system at the beginning (eg China) are not the same funds being used to settle the inwards remittance (eg the UK). Understanding and being satisfied with the source of the UK funds used in the inwards remittance is key.

In some examples, cash is deposited with a cash controller or “banker”, who then enters into a reciprocal arrangement with a counterpart elsewhere. The counterpart will then release an equivalent amount to a nominated contact in that country. Transfer of value will flow both ways and a regular reconciliation will occur. Both legitimate and criminal funds can be transferred in this way.

However, the cash element on both sides of such arrangements can be the product of criminal acts or used to finance criminality. Where you become aware that a transaction you are advising on involves the use of IVTS you should ensure that you are satisfied that you have confirmed the legitimacy of the customer’s source of funds and the source of funds used to settle the inward remittance. Because this system moves value rather than specific monies, the source of the funds used to settle the inward remittance is likely to be different to the source of the originating funds.

The cash given to a cash controller can be used for criminal purposes such as narcotics production, purchase or smuggling costs. Similarly, cash obtained in the UK can be the proceeds of organised crime (often drugs sales, cigarette smuggling or other cash-producing illegal activity). This in turn can be used to settle the inward remittances from China, either through direct cash payments to customers, or being paid into mule accounts.

Criminal Daigou

Daigou translates as ‘purchase on behalf of’ or ‘surrogate shopping’. It is a Chinese term for the purchase and sale of high-value goods (watches, jewellery etc) overseas for resale in China, without paying applicable excise duty. Criminal daigou may additionally involve fraudulent reclaim of VAT.

In the UK, daigou has been used in conjunction with underground banking to provide inward remittances for customers. In particular students - often related to the other participants in the transaction - have been noted as participants in this activity.

What this means for you and your firm

Sensitivity: General

Misleading the Chinese authorities about the reasons for a currency transfer is not a crime in the UK. The fact that a person might be knowingly misrepresenting the reasons for the transfer is, however, something to consider carefully.

Ultimately the key issue is the need to establish that the funds come from a legitimate source. You should also establish whether the client has misrepresented the reason for the transfer, and if so, why they did this and what the real purpose of the transaction is.

Documentation

The purpose of the transfer must be declared on official Chinese Government Overseas Transfer forms.

In situations where the source of funds has been ascertained as coming from China, you should consider obtaining a copy of the transfer form. However, this may not be necessary if the source of funds has been established through other methods.

The form may be useful in confirming that your client has used the formal banking system and have not made use of IVTS and will help you form a better understanding of the client's circumstances.

The form will, however, only confirm what the client has told the Chinese authorities and may not reflect the real reason for the transfer or the actual source of funds. You should not rely on this document in isolation for due diligence purposes.

Red flags, risks and mitigations

There are also various red flags that could indicate suspicious activities. These can be found on a client's banking transactions and supporting documentation. Some examples are as follows (this is not an exhaustive list):

- transfers received that are just below the threshold of currency controls that apply in China
- multiple/lump sums received from third party individuals or companies with no obvious connection to the transaction
- multiple payments made to high value goods retailers/brands, which may suggest that the person is a daigou participant
- multiple sums received in unusually similar or rounded figures
- information given in support of transfers that appears false or contradictory
- the client insisting on translating their own bank statements and/or supporting due diligence documents.

In accordance with the LSAG Guidance, you should understand and, where appropriate, obtain evidence of the source of funds (including geographical origin) to be used in a transaction.

If customer due diligence (CDD) documents are in a foreign language you should ensure you are satisfied you can understand their contents. To do so you may need to engage the services of a professional translator, unless you yourself have sufficient understanding of the language.

Reason for the transaction

Sensitivity: General

If the reason for an overseas transfer does not match the actual use of the funds you should carefully consider whether you are content to do business with a customer that has given deliberately incorrect information on an official government form. It is important that you speak to your customer to understand their circumstances.

The client's reason for doing this may appear to you to be legitimate and explainable, such as fear of political persecution, but it should still be considered an indicator of higher risk. This means in all such scenarios your starting point should be enhanced due diligence (EDD).

Source of funds and wealth

Part of your obligation in conducting CDD is to assess and obtain information on the nature and purpose of the business relationship and account/transaction in question. This information is integral to identifying the reasons for evading financial controls and whether this poses a risk of money laundering or terrorist financing.

LSAG supervisors expect you to identify and understand the source of funds for a transaction where your risk assessment has determined that the transaction presents a higher risk of money laundering, terrorist financing or proliferation financing. This includes identifying and analysing the underlying origin of the funds (including through scrutiny of bank statements) and evidencing the connection between any third-party funders and the customer.

You must take a risk-based approach to CDD. Enhanced due diligence (regulation 33) is necessary where you have assessed the situation as presenting a higher risk of money laundering or terrorist financing.

Consider performing due diligence on companies that have transferred monies. You can do this by using company registries overseas to verify the companies' business interests, business ownership and sources of wealth, because this will help to establish whether the company is trading, is solvent, and supports your expectations about the client.

You can use registries of professionals overseas (such as lawyers) to confirm professionals' standing where they have certified documents, provided due diligence or provided supporting statements.

Completing CDD

You must assemble as much CDD evidence as you need in order for you to feel comfortable about each customer matter. In accordance with sections 6.8 and 6.9 of the LSAG guidance, if you cannot complete CDD, you must not carry out the transaction and must terminate the business relationship.

You must be able to demonstrate to your supervisory authority that the extent of the CDD/EDD measures they have taken are appropriate to the level of risk.

Suspicious Activity Reporting

The UK Financial Intelligence Unit does not advise for or against submitting SARs or Defence Against Money Laundering (DAML) SARs where overseas currency laws have been broken. This means that:

- You must consider each case individually

Sensitivity: General

- It is for you to decide whether to report suspicion based on all of the information available.

Legal sector supervisors would not necessarily expect firms to make SARs where the only issue is that the purpose of the transaction was misrepresented to the Chinese government. We would, however, expect proper source of funds and/or wealth checks to support a decision not to submit a SAR. The same is true of splitting of funds via family members, though this would require a greater degree of source of funds checks to track the paths of the various monies.

Where you withdraw from a transaction because you cannot complete CDD, you must consider whether your inability to complete CDD gives rise to a suspicion of money laundering. Where you are suspicious that the proceeds of crime exist, and that reportable information is not protected by privilege you must consider your reporting obligations.