OVERVIEW

In essence a derivative contract is a bet placed on the movement of some underlying market factor, such as an interest rate, a market index, or the price of a certain commodity or stock.

If one is betting that a price will go up, then one is said to be “long” on the contract. Conversely, going “short” on a contract is a bet that the underlying value will go down.

TYPES OF DERIVATIVE

There are three main varieties of derivatives: forwards, options, and swaps.

- A forward is a contract between two parties for the purchase of an asset at a specified price at some specified time in the future.

- An option is a contract that gives the buyer the right, but not the obligation to buy or sell an underlying asset at a specified price on or before a specified date.

- A swap is a contract in which two parties exchange the cash flows from financial instruments owned by each other at specified intervals.

There are many varieties of derivatives, Derivatives can be constructed based upon other derivatives, and derivatives can themselves be bought and sold.

ADVANTAGES

The complexity of derivatives and the derivatives market provide perfect cover for hiding money laundering activity.

Indeed, the buying and selling of derivatives is usually conducted through a broker and it is quite usual for market participants to be unaware of the identities of anyone beyond the broker they are directly dealing with.
SCENARIO

A RUSSIAN CRIMINAL ORGANISATION HAS A LARGE AMOUNT OF CRIMINALLY OBTAINED FUNDS THAT IT WANTS THE OUTSIDE WORLD TO THINK HAS COME FROM A LEGITIMATE SOURCE.

THESE FUNDS ARE REGULARLY DEPOSITED INTO A BROKERAGE ACCOUNT, ACCOUNT A, CONTROLLED BY A COMPLICIT BROKER. THE GOAL OF THE BROKER IS TO PRODUCE “CLEAN” FUNDS IN ANOTHER ACCOUNT THAT HE ALSO CONTROLS, ACCOUNT B.

HERE IS THE METHOD.

A: ILLICIT FUNDS
Illicit funds are deposited into a brokerage account, Account A, controlled by a complicit broker.

B: THE BROKER
During the course of a particular trading day the broker will go both long and short on the same commodity, closing out both positions at the end of the day. In his books the broker will assign the losses to Account A, reducing the balance of the account with the “dirty” funds, and assign the profits to Account B, thus producing more “clean” money.

The broker will have had two legitimate contracts and any money taken from Account B can then be rightly claimed to be the profits of derivative trading.

C: LONG & SHORT POSITIONS
The broker will go long and purchase derivative contracts in relation to a particular commodity and at the same time the broker will also go short and sell the same number of derivative contracts in relation to the same commodity. Later in the trading day, the broker goes back to the market and closes out the two open positions.

Let us assume the price of the underlying commodity has gone down. This means that the long position will have lost money and the short position will have gained a profit. The broker then simply assigns the long (and hence losing position) to Account A and the short (and hence winning position) to Account B.

D: THE SPREAD
There will of course have been a difference in the offer and bid price on the various contracts, known as the “spread”.

So the amount of profit of the winning position will be less than the amount of the loss of the losing position. This difference is the price of laundering the money.

E: CLEAN FUNDS
Money taken from Account B can then be claimed to be the profits of derivative trading. The winning position may have made a profit of $50,000 while the losing position will have lost $60,000. Therefore it will have cost $60,000 in tainted funds in order to generate $50,000 in “clean” funds.