Implementation of the Third Money Laundering Directive – an overview

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The EU Third Money Laundering Directive which is due to be implemented across the EEA by December 2007 brings significant changes to the existing regime governing anti-money laundering compliance by an ever expanding ‘regulated sector’. This article aims to highlight the most significant changes to be introduced by the Directive and propose practical steps which investment firms and banks may wish to adopt in order to adequately accommodate such changes.

A. Background

Let us start with a controversial statement: money laundering is “big business” – a slightly twisted concept but nonetheless true. The International Monetary Fund has estimated the scale of global money laundering as the equivalent of between 2 and 5 per cent of the world’s gross domestic product. The UK Home Office has estimated the economic cost of serious crime in the UK to be between £19bn and £48bn per year.¹

The global fight against money laundering and its related adverse phenomenon, terrorist financing, has seen a considerable rise in attention since the tragic events of 11 September 2001. In the UK, the coming into force of the Proceeds of Crime Act 2002 (“POCA”) marked an important step in strengthening the principal criminal law regime designed to tackle money laundering in general. The Terrorism Act 2000 is the principal UK legislative provision in the battle against terrorist financing. To demonstrate the rise in awareness of anti-money laundering and terrorist financing compare the following statistics. During 2005 a total of 195,000 Suspicious Activity Reports were made to the enforcement authorities (mainly NCIS). During 2000, fewer than 20,000 such reports were made to the enforcement authorities.²

The international community has spearheaded this global fight through the Financial Action Task Force (FATF), an intergovernmental body which seeks to develop and promote national and international policies to combat money laundering and terrorist financing. There are 40 (plus 9 Terrorist Financing) Recommendations (the “FATF Recommendations”), which were most recently revised in October 2003.

The EU Third Money Laundering Directive 2005/60/EC (the “Third Directive”) was adopted in October 2005 and must be transposed into national laws across the EEA by 15 December 2007. The main objective that the Third Directive set out to achieve is to align the EEA regulatory regime applicable to tackling money laundering and terrorist financing with the FATF Recommendations. The UK published the Draft Money Laundering Regulations 2007 (the “Draft Regulations”) for consultation in January 2007. The Draft Regulations will transpose the Third Directive and repeal and replace the Money Laundering Regulations 2003 (the “2003 Regulations”).

The Third Directive emulates the prevailing modern thinking in financial services regulation, which advocates the setting out of flexible requirements and facilitates a risk-based application of such requirements in practice, which may vary according to the circumstances. This is consistent with the UK’s “better regulation” agenda, as manifested in a number of recent governmental taskforce missions, which dictates that regulation should be proportionate and flexible in a way that minimises the burden on market participants and facilitates delivery of regulatory objectives but does not stifle innovation or disadvantage UK-based businesses.

The UK government has also committed to avoid the practice of “gold-plating” EU legislation unless there are exceptional reasons for doing so.³ This approach is being applied to the implementation of a number of current European legislative measures, most notably the implementation of the EU Markets in Financial Instruments Directive, which is seen by many as the most significant overhaul of the regulation of investment firms and securities execution venues in recent times.

In line with the prevailing approach set out above, the UK government is intending to take full advantage of the derogations allowed for under the terms of the Third Directive. The Third Directive will affect a wide range of existing and new sectors of businesses in the UK, Northern Ireland and Gibraltar but will not apply to other Overseas Territories or to the Crown Dependencies (e.g., the Channel Islands).

HM Treasury originally estimated the total cost of implementing the Third Directive to be between £5m and £46m per year.⁴ The main impact according to such assessment would be due to the more detailed “know your
customer” procedures, enhanced due-diligence obligations, and the new requirement for trust and company service providers to be licensed or registered and subject to “fit and proper” vetting. Most surprising, however, is the prediction of HM Treasury that the financial services sector (banks and investment firms) will have only minor additional costs as a result of the implementation of the Third Directive. This article will seek to give this prediction a “reality check”.

Whilst this article is written from the point of view of investment firms and banks, it intends to discuss the most fundamental general changes that will occur as a result of the implementation of the Third Directive.

B. Scope

The Third Directive significantly broadens the scope of persons subject to regulation in such way to include, for the first time, trust and company service providers.

Importantly, the definition of persons who fall within the scope of the Third Directive will now be referenced to categories of persons as opposed to engagement in certain prescribed activities. This approach is very likely to increase the number of persons caught within the scope of the Third Directive. For example, the Third Directive defines a “financial institution” (which is subject to the Third Directive) as any undertaking that carries out one or more of the activities listed in Annex I to the EU Banking Consolidation Directive. The list contained in Annex I goes well beyond those activities regulated by the UK Financial Services Authority (FSA) and by reference to which the 2003 Regulations operate. Examples of these activities include financial leasing, commercial lending, money broking, and the provision of guarantees and commitments.

HM Treasury has taken advantage of the scope derogation contained in Article 2 of the Third Directive to exempt from the Draft Regulations (through Draft Regulation 2(7)) persons who engage in financial activity on an occasional or on a very limited basis (such persons must meet both a quantitative and a qualitative test). Additionally, persons who are dealing for their own account and not providing a service to a customer would not be regarded as financial institutions (which are subject to the Third Directive) for that reason alone.

Whilst the Third Directive extends the definition of the term “money laundering”, such definition still falls short of the “all offences” definition inserted by POCA so as to bring no impact in this respect in the UK.

The Third Directive extends the scope of the EEA anti-money laundering regime for the first time to activities associated with terrorist financing. However, this will have no impact on current UK legislation, which already contains terrorist financing provisions that are at least equivalent to those of the Third Directive.

C. Enhanced customer due diligence

The Third Directive adds a great deal more detail to the current customer due-diligence requirements as set out in the 2003 Regulations, but at the same time provides certain grounds where simplified due diligence may be applied. However, it should be noted that firms in the banking and financial services sector currently adhere (to varying degrees) to the Guidance Notes for the UK Financial Sector issued by the Joint Money Laundering Steering Group (“Guidance Notes”) (last updated in January 2006). Most of the areas that will see formal prescription for the first time through a statutory measure (the Draft Regulations) are already covered by the scope of the Guidance Notes.

On this basis, one may argue, financial services firms and banks need not do much to accommodate the Draft Regulations as their procedures may already be compliant with the standards set out in the Third Directive. However, taking such an approach would of course involve certain risks in light of the fact that the Guidance Notes comprise a voluntary code of conduct (albeit one that is endorsed by HM Treasury for the purposes of assessing a person’s conduct in connection with certain offences under POCA and generally by the FSA). The elevation of the detailed requirements from the level of a code of conduct to that of provisions in statutory materials which are backed by enhanced enforcement (criminal and civil) powers certainly merits at least a “health check” in order to ensure that the current approach taken by firms and banks is consistent with the letter and the spirit of the requirements of the Third Directive.

The Draft Regulations (at Draft Regulation 4) require any person falling within the regulated sector to identify, where applicable, the “beneficial owner”s of the customer. Whilst the relevant Draft Regulation provides seemingly wide discretion for firms in determining what measures are appropriate for verifying the identity of the beneficial owner, it is debatable whether the provisions contained in the Guidance Notes in connection with identification of beneficial owners (at 5.4.84, 5.4.87-91, and 5.4.141-42) are wholly consistent with the requirements of the Third Directive.

Draft Regulation 4 goes further to require “ongoing monitoring” of the business relationship with each customer. This requirement embeds two sub-requirements. First, there is a requirement to monitor all transactions with or for the customer to ensure that such transactions fall within the scope of the business disclosed by the customer at the outset. This is to a large extent already factored into firms’ (mostly automated) monitoring systems. Secondly, and most significantly, there is a requirement that the documents, data or information held on record by the relevant person are kept up to date. The practical question raised by the second requirement is the determination of the “shelf life” of documentary evidence obtained from customers. This will be a fundamental question determining the scope, if any, of what may be gigantic exercises (in the context of large firms) to refresh information on record. Firms will have to deploy sophisticated information technology systems alerting them to any information becoming stale in accordance with the subjective parameters decided by each institution (or provided through an industry consensus). It is suggested that the Guidance Notes’ brief treatment of this topic (at
5.4.12) may provide an insufficient degree of comfort for firms to ensure that they do not fall foul of this requirement.

Where the beneficial owners of a customer are a group of undetermined individuals (e.g., discretionary trusts) it will be sufficient to identify the class of persons in whose main interest the legal arrangement is established. Furthermore, corporate trustees will be able to utilise the provisions of paragraph 13 of the Preamble to the Third Directive in relation to bond market activities. The Preamble (which was added at the insistence of the UK government and is implemented through Draft Regulation 5) states that the mere existence of a trust relationship in a commercial product will not in itself give rise to an obligation to establish the beneficial owner.

Under the Third Directive, customer due-diligence measures must be carried out upon establishing a business relationship but also in the following situations: where there is a suspicion of money laundering or terrorist financing; where there are doubts about the veracity or adequacy of previously obtained customer identification data; and regarding existing customers, on a risk-sensitive basis. The first of these occasions appears to contradict the “tipping-off” provisions set out in POCA as they may alert a person to an enquiry. The last of these occasions is unclear in its scope (i.e., what criteria should be applied by firms in order to determine which existing customers are subject to this process?) but the Consultation Document issued by HM Treasury in July 2006 suggests that there is no intention to require retrospective identification of all existing customers on a regular basis. This issue is one amongst a number of topics where HM Treasury has been unwilling to provide meaningful guidance for firms on what conduct would achieve compliance with the requirements of the Third Directive.

Unlike the requirements in the 2003 Regulations which specify that customer due diligence must be conducted “as soon as reasonably practicable after first contact is made”, the Third Directive prohibits the establishment of a business relationship or conduct of transactions prior to due diligence checks being completed. However, a relationship may be established (and occasional transactions executed) in situations of low risk and where dealing is necessary in order to prevent an interruption with the normal conduct of business. Additionally, business relationships in connection with life insurance policies and non-functioning bank accounts may be undertaken subject to certain safeguards.

The Third Directive lays specific requirements in connection with cross-border correspondent banking with non-EEA firms. These include obtaining adequate levels of information, assessing the entity’s anti-money laundering controls, obtaining approval from senior management for the relationship and documenting respective responsibilities. Firms must ensure that the correspondent bank has verified the identity of customers having direct access to accounts and is able to provide data feed on request.

Transactions or business relationships with Politically Exposed Persons (PEPs) will be subject, for the first time, to prescribed statutory requirements. The provisions of the Implementing Directive (Level 2) set out further prescriptions of persons (at European and international level) falling into the definition of PEPs. The Draft Regulations require that firms identify a PEP when they encounter it, obtain the approval of senior management to the proposed relationship, and establish the source of wealth and funds of the PEP. Relationships with PEPs must also be the subject of enhanced monitoring. Banks and firms that view themselves as particularly susceptible to being used by PEPs (e.g., private banks) are expected to employ systems appropriate to the perceived risk, which has been suggested by HM Treasury to include subscription to specialist, commercially available PEPs databases. Despite strong industry demands, the UK government has confirmed that it will not issue a conclusive list of “foreign PEPs” in the Draft Regulations or otherwise. The burden is therefore placed on firms to monitor any updates issued by the EU Committee on the Prevention of Money Laundering and Terrorist Financing and any further information made available by the UK government in conjunction with law enforcement agencies. This open-ended nature of the definition is clearly unsatisfactory and requires firms to dedicate ongoing resources to this challenge.

D. Simplified customer due diligence

To counteract the perceived substantial added burden as a result of the enhanced customer due-diligence requirements set out above, the Third Directive expands the circumstances in which firms may apply simplified due-diligence procedures. The UK has taken full advantage of such circumstances (including discretionary derogations). One significant factor, however, which tends to be underestimated in this context, is that firms will in any event have to take steps (and retain records of such steps) to prove that the customer concerned (or the relevant product) does indeed comply with the set requirements of “low risk”. Furthermore, whilst the vast majority of the due-diligence requirements will be disapplied, firms will be expected to monitor the relationship as they would in connection with any other customer. It is unclear why firms need to apply the monitoring requirement to these designated “low-risk” customers, products and services, and what such monitoring should in practice mean in this context.

E. Branches and majority-owned subsidiaries in non-EEA countries

The Third Directive introduces a new requirement on EEA banks and investment firms to apply due-diligence and record-keeping measures within their non-EEA branches and majority-owned subsidiaries which are at least equivalent to the requirements set out in the Third Directive. Where the legislation of the relevant jurisdiction does not permit such measures to be implemented, the bank or firm must notify its home regulator of such impossibility and take “additional measures to handle effectively the risk of money laundering or terrorist financing”. These provisions are the first of their kind requiring mandatory harmonisation of customer due-diligence requirements on a group-wide basis.
Whilst some banks and firms are already in the process of integrating their approach to anti-money laundering compliance, the fact of the matter is that there are still significant differences between applicable regimes within but especially outside of the EEA. This task would involve a delicate and painstaking process for the larger cross-border operators.

F. Anonymous accounts and shell banks

The Third Directive places an absolute prohibition on keeping anonymous accounts (without any transitional period). Additionally, the Third Directive prohibits the entering into correspondent banking relationship with a shell bank or with a bank that permits its accounts to be used by a shell bank.

G. Reliance on third parties

The 2003 Regulations currently provide for a very limited scope for reliance on third parties’ due-diligence processes in the context of a one-off transaction introduced by the firm on whom reliance is being placed. The Guidance Notes extended the scope of occasions where reliance can be placed and provide for various standard form reliance certification designed to achieve a level of certainty in this area.

The Third Directive allows regulated sector firms to rely on any other regulated sector firms for the purposes of undertaking customer due-diligence processes provided that such firm is subject to mandatory professional registration and, in the case of third countries, equivalent regulation and supervision. Consequently, greater cross-border emphasis and reliance could be placed on eligible third parties to obtain information about the purposes and intended nature of the business relationship as well as information that verifies identity. The UK government has chosen, however, to adopt a staged implementation approach and exclude for the time being the possibility of relying on casinos, money service businesses, trust and company service providers, consumer credit firms, and legal and accountancy professionals who are not currently supervised by their professional bodies for the purpose of anti-money laundering compliance.

Nonetheless, firms must maintain ultimate responsibility and have appropriate systems and controls to ensure that reliance is safe (including in circumstances of intra-group reliance). Where reliance is envisaged to recur regularly, these should involve, at a minimum, observing the procedures manual deployed by the relevant firm. The Third Directive requires that third parties on whom reliance is placed must be under obligations to provide (on request) copies of identification and verification data and other relevant information and documentation on the customer or the beneficial owner.

H. Enforcement powers

The Draft Regulations bestow unprecedented levels of powers on the FSA, HM Revenue and Customs, and the Office of Fair Trading to request information; require persons in the regulated sector (or persons connected with them) to attend interviews; and enter and inspect premises with (subject to certain safeguards) or without a warrant. Similarly, the enforcing authorities will have powers, for the first time, in respect of failures to comply with the anti-money-laundering regime, to impose civil penalties for, amongst others, failures to observe the customer due-diligence requirements and the mandatory registration requirements (for high-value dealers, money service businesses and trust and company service providers). It is notable in this context to mention a further new requirement introduced by the Third Directive for investment firms and banks to have systems in place that enable them to respond fully and in a timely fashion to enquiries from, in the UK, the Serious Organised Crime Agency or any other enforcing authority (eg, FSA) as to whether they maintain or have maintained during the previous five years a business relationship with specified natural or legal persons and, where relevant, the nature of that relationship. These requirements mean that banks and investment firms must review their internal rules and policies so as to facilitate a swift retrieval of relevant information in response to any requests made.

I. Conclusion

It is self-evident from the above discussions that the implementation of the Third Directive in the UK will have a significant impact on the procedures, systems and controls of banks and investment firms. Whilst there are a number of areas where the required standard of conduct will be unveiled over time, it is no doubt fundamental that firms undertake a “gap analysis” to ensure that they remain off the radar screens of the regulator and other enforcing authorities.

4 HM Treasury Budget, 2005.
5 HM Treasury, The Third Money Laundering Directive: Regulatory Impact Assessment 2005. This estimate was updated in the HM Treasury Consultation Document of July 2006 to be around £28m.
6 The person who ultimately has ownership and control of the customer or person on whose behalf the activity or transaction is being conducted. In the case of a body corpo-
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rate: individuals with at least 25 per cent of voting rights or otherwise exercises control over the management.

7 See Regulation 4(3)(a) of the 2003 Regulations.
8 See Art 9 of the Third Directive.
9 See Art 13(3) of the Third Directive.
10 Natural persons who are or have been entrusted with prominent public functions and immediate family members, or persons known to be close associates, of such persons.
11 Directive 2006/70/EC.
12 See Draft Regulation 10(4) of the Draft Regulations.

14 See the Accompanying Narrative to Draft Regulations.
15 See Art 31 of the Third Directive.
16 A bank incorporated in a jurisdiction in which it has no physical presence involving meaningful decision making and management and which is unaffiliated with a regulated financial group.
17 See Arts 6 and 13(5) of the Third Directive.
18 See s 4 of the Third Directive. Member States will issue lists of equivalent countries in consultation with the Commission.
19 See Part 5 of the Draft Regulations.
20 See Draft Regulation 14(5) of the Draft Regulations.