



The Law Society

Financial Action Taskforce Consultation Response

Reviewing the standards - preparing for the 4th round of mutual evaluations

January 2011

supporting
solicitors

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1. Introduction

This response has been prepared by the Law Society of England and Wales (the Society), which represents over 140,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and lobbies regulators, governments and others. The Society is the anti-money laundering supervisor for solicitors in England and Wales and also supports them in compliance through the provision of advice, awareness raising and education.

The Society welcomes the opportunity to respond to FATF's review of the standards in preparation for the 4th round of mutual evaluations.

1.1. The role of the legal sector

For many years the Society has publicly recognised:

- that there is a clear social justification for a prohibition on concealing and using the proceeds of crime;
- there is no role for solicitors in actively assisting criminals to launder the proceeds of their crime, such conduct being prohibited by our professional code of conduct as well as the criminal law; and
- as gatekeepers to the legal system and facilitators of many significant commercial transactions, solicitors have a role in achieving the aims of anti-money laundering measures.

However, for some time the Society has been concerned that the current application of the standards is not sufficiently focused to produce the most proportionate and effective contribution by the private sector to the aims of global anti-money laundering regime. The direct application of standards designed for financial institutions to law firms, without proper consideration of the different way in which law firms interact with clients and how money laundering risks can crystallise within retainers, is causing inefficiencies. There are a number of other aspects within the standards where a blanket approach to certain types of risks has been applied. This is resulting in wasted resources which cannot then be targeted to the areas of real risk.

The Society is committed to advocating for anti-money laundering standards which are clear in law, practically achievable by regulated entities and proportionate to identified risks. We hope that the comments within this submission assist in reviewing the standards so that the standards can better achieve those aims.

1.2. Preparation of this response

This response has been informed by numerous consultations and our work on anti-money laundering with the legal profession in England and Wales over the past decade.

This response has specifically been prepared with assistance from the members of the Society's Money Laundering Taskforce, with representatives from:

- BCL Burton Copeland
- Boys & Maughan

- Byrne & Partners
- Freshfields Bruckhaus Deringer LLP
- Herbert Smith LLP
- Hogan Lovells LLP
- Irwin Mitchell LLP
- Kingsley Napley LLP
- Pannone LLP
- Slaughter and May

1.3. Terminology

Where we have referred to regulated entities in this response, we are referring to both financial institutions and designated non-financial businesses which are covered by the standards. Where we are referring solely to law firms in England and Wales and to our members, we have made this clear.

2. General concerns about the consultation

While the Society welcomes the opportunity to contribute to the first public consultation on the standards in many years, we do have some concerns about the current consultation process.

Reading through the consultation document, one is given the sense that decisions have already been taken on what changes may be discussed and even how some of those changes will be made. This suggests that there will be little scope for the private sector to provide suggestion as to how the standards could be refocused to promote more effective engagement from the private sector. Whilst we support many of the principles, we believe that in order for the proposals to be truly effective, it is vital to understand and take account of the practical implications on the private sector of nuances in the drafting.

We are further concerned that we are asked effectively to sign up to change in principal, without a clear idea of how that change will in fact be implemented. A clear example of this is at paragraph 16 of the consultation document, where consultees are asked to comment upon lists which have been drawn up but are not provided. While in principal some of the proposals may seem attractive generally, there is a real risk that in translating these into detailed standards, the specific wording may produce unintended consequences which consultees and FATF itself may not have supported.

We would encourage FATF to consider how the private sector can be given an opportunity to comment on the actual proposed drafting in the context of its general consultation processes. We would note that the involvement of the private sector was very effective in the context of the consultations on the risk based approach (RBA) guidance for the different sectors.

We are also concerned that the time frames for the consultation leave very limited time for assessing and assimilating any new ideas which are clearly supported as a result of this public consultation and more importantly for the public consultation on Recommendations 33 and 34. We are concerned therefore that there will be no

meaningful consultation on these further issues and would ask FATF to reconsider the proposed time table.

Finally, a number of the issues covered in this consultation are significantly inter-related to the application of recommendations 33 and 34 on beneficial ownership. Without information about the proposed changes to those recommendations, it is quite difficult to form a clear view on the effect of the changes proposed in this consultation. Accordingly, we would ask FATF to ensure that there is an opportunity to further consult fully on these issues in the second round of consultation, so that any changes take into account the very real challenges faced by the private sector relating to beneficial ownership.

3. Interpretive note on the risk based approach

The Society has long been supportive of the risk based approach in anti-money laundering compliance. Each segment of the regulated sector, each client and each product or service line has different risks and as a result, there are different opportunities for mitigating those risks. The risk based approach, when properly applied, allows regulated entities to tailor their compliance so that they can meet the risks that they face most effectively.

The Society believes that the work undertaken by FATF in producing sector specific guidance on the risk based approach was of significant value, due to the varied nature of anti-money laundering risk. We are pleased to have contributed to the preparation of the RBA guidance for the legal sector.

Given that there has been such valuable work undertaken on these guidance documents, we do wonder what can be added to the fight against money laundering by the introduction of an interpretive note on the risk-based approach, particularly with respect to regulated entities.

Our perception, which may be misplaced, is that the initial outline of proposals promotes a return to a one-size-fits-all approach. We are particularly concerned that where FATF requirements have been gold-plated nationally, statements that a particular type of client or transaction will always be high risk can undermine the effectiveness of the risk based approach and the work already undertaken in the sector specific RBA guidance.

When considering the focus on the proposed risk assessments FATF needs to consider the size, complexity and resources of the vast majority of the regulated entities to whom their standards apply so that firms can apply a proportionate, flexible and risk based approach. It is important to note that while there are a number of large multinational banks, lawyers, accountants and casino operators, the vast majority of regulated entities are small to medium sized businesses¹. While most are determined to comply with their legal and ethical obligations, given the size and make-up of such firms few will have the resources to conduct detailed risk assessments. Most will be taking a more generalised risk approach to areas of law and then to particularly unusual clients. This approach has been recognised as realistic for some law firms in the RBA guidance for the legal sector.

¹ In the legal profession in England and Wales around 40% of law firms are sole practitioners and a further 45% of law firms have 4 partners or less.

<http://www.lawsociety.org.uk/secure/file/183555/e:/teamsite-deployed/documents/templatedata/Publications/Research%20Publications/Documents/asr2009report.pdf>

We would be concerned if such proportionality were to be lost as a result of a new interpretative note.

In terms of the proposals regarding risk management and mitigation, we would also suggest that any reference to policies and procedures complying with guidance should be to national sector specific guidance, as this is the standard which firms are actually assessed against.

4. Amendments to Recommendation 5 – client due diligence

4.1. Examples of high and low risk situations

As outlined at point 2 above, our response on this point would have been more focused had the pre-decided lists of high and low risks been included in the consultation. We will try to address the issues to the extent they have been foreshadowed in the consultation.

The Society supports the idea of more information being provided on different risk situations, but again questions whether the standards and interpretative notes are the most effective way of providing that information. As outlined previously, anti-money laundering risks vary according to the different sectors and even between regulated entities within sectors. The provision of more “nuanced or focused information through methodologies and the RBA guidance is preferable to statements that certain types of clients, products or jurisdictions will “always” be a higher risk for all regulated entities and all of the products or services they provide, which does not reflect the reality.

A clear example of this is the current treatment of politically exposed persons (PEPs) on which we elaborate further at point 7 below. At present, all PEPs are assumed to be a risk simply because they have access to government or state funds. While it is accepted that there is a risk that a PEP will have accepted a bribe or misappropriated government funds because s/he has greater access to these funds than the average citizen, that does not mean that all PEPs are corrupt. Where a PEP is purchasing a modest family home with the proceeds of the sale of their former home and a mortgage, there is very little money laundering risk. The risk is even less so when it is the sibling of a primary PEP undertaking the same transaction. Yet because PEPs have been singled out in the standards as a specific high risk indicator, regulated entities are required to conduct enhanced due diligence and monitoring irrespective of the real risk of the individual client and the individual transaction. This is leading to firms undertaking significant due diligence to protect themselves from sanctions for regulatory breach rather than from a real risk of money laundering.

By contrast, it is not generally accepted that simply because accounts clerks have increased opportunity to steal from their employer or pharmacists have increased access to prescription medication which they could be selling illegally, they should all be treated high risk. That would not generally be considered risk based or proportionate, and the key focus should be on situations where there are other warning signs of money laundering, such as attempted use of unexplained private funds. Arguably, therefore the same should be said for the approach to PEPs.

We believe an “in-principle” statement about how to approach higher risk situations would be more effective within the standards, rather than an interpretative note specifying set situations which should always be treated as high risk even if in fact they are not. More targeted information could then be provided about situations which may pose a higher risk to different sectors in methodologies and sector specific guidance.

4.2. Beneficial ownership

The Society accepts that sophisticated criminals will seek at times to hide behind business structures and agents to help facilitate money laundering. For this reason we appreciate that a greater understanding of the client's ownership and control structure can be of use for regulated entities to better understand the motivation behind transactions and spot anomalous activities or relationships which may be indicative of money laundering.

However the existing standards require regulated entities to actively seek out an individual at the top of a corporate tree with the requisite interest, irrespective of the inherent risk posed by the client or the transaction. Often this results in the firm simply confirming that there is in fact no such beneficial owner in existence. There are real challenges involved in the current requirements resulting in detailed due diligence regardless of any concern that there is any risk in terms of the overall transaction.

This failure to fully apply a risk based approach to the identification of beneficial owners is of significant concern to the Society and our members, in part because of the waste of resources. We are pleased that FATF is looking at the proportionality and effectiveness of the client due diligence requirements as they apply to beneficial owners.

4.2.1. Agency

The Society appreciates that ensuring a person is authorised to act as an agent is a useful fraud prevention step. However we are concerned that these proposals are seeking to impose a legislative requirement on regulated entities to prevent predicate offences as well as money laundering.

The existing standards already require that you identify your client and the beneficial owners, which includes a person on whose behalf the transaction is undertaken. This clearly covers agency situations. The focus is on identification, to reduce the risk of criminals using false identities and money mules to help in the concealment of the proceeds of their crime. The Society believes this is an appropriate topic for FATF to deal with.

However to go further and insist upon obtaining evidence of authority to act, is to create an entirely new legal burden on parts of the private sector. Such an approach would confuse client identification and verification with corporate authority. While many firms will already make some enquires about such authority, this is an issue of contract law and the law of negligence not one of money laundering regulation. To make it a legislated requirement, potentially backed with criminal sanctions, is a clear example of inappropriate regulatory creep and obtaining such confirmations will not have any bearing on the fight against money laundering.

4.2.2. Mind and management of the firm

As we have already said, the Society is in favour of a more pragmatic and risk based approach being taken to beneficial ownership. We understand from discussions with others who have been more closely involved with FATF that this proposal is meant to achieve such an aim. Over many years, at all levels, we have seen that despite the best of intentions, a failure to achieve precise drafting results in those intentions being frustrated. Our concern here is that not only will the actual drafting will be crucial to achieving the stated aim but also that at present the suggestions outlined in the consultation document seem to be making the task of identifying and verifying beneficial owners more not less complicated.

Rather than allowing for a more pragmatic and broad brush approach to beneficial ownership in low risk situations, the current proposals appear to require full compliance with the existing regime in all cases; namely searching for one or more named individuals who control the entity. We are very concerned that the proposals then seem to be applying an additional obligation, that should such named individuals not be located, regulated entities must then go in search of some other person or group of people who may be the mind and management of the entity, even though they possess none of the classic indicators of control – such as voting rights.

We believe that this is an impossible request. It may be that we have misunderstood the intention regarding changes in this area. Alternatively, FATF may be planning to provide clear, practical guidance as to how regulated entities should, regardless of risk, not only locate such individuals but also be confident that they can demonstrate to the regulators that they have undertaken sufficient due diligence, in a cost effective manner.

We encourage FATF to engage in detailed consultation with the private sector to discuss how the real issues and risks around beneficial ownership can be addressed in a way which is practically achievable, proportionate and effective.

4.2.3. The practical problems

The Society and our members are supportive of the provision in Recommendation 5 which enables regulated entities to verify the information on beneficial ownership by non-independent means, because often it is the only way in which they can actually comply with the requirements.

In practice, even within the UK, much of the beneficial ownership information that regulated entities must obtain is not available through independent channels. Recent amendments to the UK legislation governing the inclusion of data on the Companies House register saw the removal of the private addresses of company directors, to help combat fraud and harassment from activists. While verification of this particular piece of identifying information is not specifically required in the UK, in practice it has been useful for higher risk entities and transactions. The removal of such information from publicly available sources demonstrates that there are competing interests to be taken into account when setting the standards for anti-money laundering compliance and when assessing the actual achievability of the measures by regulated entities.

When trying to establish beneficial ownership in jurisdictions outside of the UK, possibly where the risk of money laundering increases, such information is practically impossible to obtain from an independent source. Where there is no ability to independently verify this information, our members feel particularly vulnerable and question the efficacy in taking the time to collect information which could turn out to be completely false. This lack of reliable information tends to result in our members seeking copious amounts of documentation from a wide range of intermediaries (such as banks, other legal advisors, accountants, investment advisors and auditors) as well as the client to seek to develop a consistent picture of the ownership and control structure of the client. This is irrespective of the level of risk posed by the client generally or by the specific transaction. The costs of such research are considerable, often not recoverable and create significant tensions with the client who cannot understand the purpose of such detailed investigation.

The multi-layering of business entities is a reality of global corporate life. For firms operating in an international context they often find themselves following a corporate chain of not merely two or three levels, but of many more. At this point, even the most forthcoming and well meaning client is unable to assist in identifying the ultimate individual who beneficially owns them, possibly because one simply does not exist or because if they do, they are so far removed from the client that actually they do not exert any real control over the client or their transactions. Our members are finding that they then have to get the contact details of management or general counsel of an entity three-quarters of the way up the corporate chain, explain to them that they have this subsidiary which would like to undertake a basic transaction, but UK law requires this entity to provide extensive details about their own ownership structure. Needless to say, many such entities when contacted fail to see the relevance or benefit for themselves or how such information will assist in the fight against money laundering. Law firms acting in a global market place, where other non-UK lawyers either have no requirement to undertake these checks or do not undertake them so diligently are finding that this can be a significant disincentive for international clients to instruct them, all other things being equal. This clearly has a potential impact on global competitiveness.

Added to the above, there is also the issue of costs of beneficial ownership CDD, which in many cases far outweigh the benefits. Unfortunately most law firms, in common with most banks and other regulated financial entities, fail to record time spent on AML compliance specifically.² Therefore it is difficult to accurately estimate the cost of client intake for different size corporate clients. However, we have been advised by some of our members that the opening of a new international corporate client matter can cost in the region of £5,000 due to the chargeable time lost by fee earners and compliance staff in chasing documents and undertaking research, even in circumstances that generally would not be considered to give rise to a risk of money laundering. Even for smaller law firms, the opportunity cost of time spent on conducting due diligence checks on any client who is other than the absolute standard, is more than the fees they are able to charge for the work being undertaken. This either results in them taking on the client at a loss in the hope of future work or in simply turning away possible legitimate business.

4.2.4. Suggestions for change

In light of these practical problems the Society would advocate the following changes to Recommendation 5:

1. Identification of beneficial ownership, rather than just the verification of such ownership, be permitted to be undertaken on a risk-sensitive basis
2. A greater focus be placed on the existing requirement to understand the general ownership and control of the client, rather than a specific pursuit of named natural persons, unless there are other warning signs of potential money laundering.

² Anti-Money Laundering Survey. PWC, 2007, page 4
<http://www.ukmediacentre.pwc.com/Content/Detail.asp?ReleaseID=2384&NewsAreaID=2>

Anti-money laundering compliance by the legal profession in England and Wales, Law Society, 2009, page 19 <http://www.lawsociety.org.uk/new/documents/aml/amlcompliancereview.pdf>

We believe that this approach would ensure that regulated entities are still required to understand who their client is, but would limit the resource intensive profiling of clients' ownership chains to those situations where there is a real risk of money laundering.

We do not believe that a requirement for regulated entities to establish the 'controlling mind' of the organisation will be more effective and we believe there will be significant practical challenges in applying such a requirement.

These views are of course subject to reviewing any proposals for change regarding Recommendations 33 and 34.

4.3. Life Insurance policies

The Society welcomes the proposals to refine the application of client due diligence requirements for life insurance policies and to understand that beneficiaries under the policies are not beneficial owners or customers as currently understood within the standards.

We believe that consideration should be given to taking a similar approach with trusts due to their similarities with life insurance policies. If the money which is placed into them at the start is clean, it is only the trustee investing the money who can commit criminal activities to taint the property. Beneficiaries of both common law trusts and life insurance policies have no real control over the funds until such time as they are paid out. Further, even if the beneficiary is a convicted criminal, it is not money laundering to give them money which is actually clean. Therefore it would seem unproductive to be focusing limited resources on identifying people for money laundering purposes when they are not the source of the funds and are unable to control how the funds are dealt with. We hope that a similarly pragmatic and effective approach will be offered in the consultation on Recommendation 34.

5. Amendment to Recommendation 8 – high and emerging risks

5.1. Non face-to-face requirements

The Society welcomes the review of the blanket assessment of enhanced money laundering risk for non face-to-face clients. In the modern world the conducting of business at a distance is a reality and the vast majority of transactions are legitimate. Different sectors will be exposed to non face-to-face risk in different ways and will have different ways of effectively mitigating that risk. For some, enhanced initial CDD will be appropriate, but for others enhanced monitoring and information on source of funds will be more effective for mitigating money laundering risks. In line with our earlier comments, we are of the view that Recommendation 5 already requires higher risk categories to undertake enhanced due diligence. In line with our earlier comments, we believe that the removal of this section from Recommendation 8 does not require replication in an interpretive note, but would be more appropriately addressed in the relevant typologies and sector specific RBA guidance.

5.2. Risks of new technologies

Turning to the issue of the risks posed by new technologies, the Society is concerned that FATF should not seek to be too prescriptive in the standards on this issue. The private sector who develop new technologies are well placed to aid government and law enforcement in identifying risks and suggesting appropriate steps to mitigate those risks. Further, the detail of the steps to be taken to mitigate these risks should be included in the typologies reports and sector specific RBA guidance.

6. Amendment to Recommendation 20 – application to new entities

It is not clear from the consultation what ‘other financial institutions or businesses’ exist which are not already covered by the definition, or which might be covered by the proposals for quite a wide right to extend the scope of the standards. The Society is concerned about the risk of regulatory creep being permitted by FATF without clear evidence of specific risk and an indication that the application of the standards will assist in mitigating the specific risks.

7. Amendment to Recommendation 6 - politically exposed persons

Recommendation 6 requires all firms to apply enhanced due diligence on all foreign PEPs, irrespective of the risk posed by the individual PEP or the specific transaction. As highlighted already, this non-risk based approach is costing firms significant amounts of money, providing practical difficulties in terms of establishing source of funds, and at times limiting the provision of legal services to legitimate individuals.

7.1. Evidence of the threat posed by PEPs

Research from the World Bank suggests that between US\$20 billion and US\$40 billion is taken from developing countries by corrupt leaders and applied for their own personal use, outside of their home country. However, that research, while not attempting to quantify the number of PEPs, acknowledges that not all PEPs are corrupt, in fact most are not and those that are, are likely to be a small percentage of PEPs.³

Recent reports from the World Bank⁴ and Transparency International⁵ on politically exposed persons failed to:

- provide any evidence for the scale of the PEP threat of money laundering globally other than ‘guesstimates’

³ Stolen Asset Recovery, Politically Exposed Person, A policy paper on strengthening preventive measures, World Bank, 2009 <http://siteresources.worldbank.org/EXTSARI/Resources/5570284-1257172052492/PEPs-ful.pdf>

⁴ Note 3

⁵ Combating Money Laundering and Recovering Looted Gains, Transparency International UK, 2009 <http://www.transparency.org.uk/publications>

- provide any detailed methodologies being used by less obvious PEPs or information on the number of these less obvious or related PEPs actually being used or discovered
- really consider the costs incurred by the regulated sector and whether those costs could actually produce greater benefits
- appreciate the fact that the majority of businesses required to apply these PEP requirements are not large banks with computerised client databases and large compliance budgets, they are small businesses with paper-based systems
- take into account the infringement of fundamental human rights of privacy for the vast majority of non-corrupt PEPs being covered by their wide ranging and very intrusive recommendations

The Transparency International report and a further series of case studies from Global Witness⁶ reports did provide some actual examples of activities by corrupt PEPs. In all of the examples provided it was clear to the regulated entity that they were dealing with a high level PEP, there were significant corruption risks in the home jurisdiction of the PEP, and generally the funds being used were not funds to which the PEP should have had access at all or should not have been used for the purposes they were used. In all of the examples provided the regulated entity simply needed to comply with legal and ethical imperatives not to engage in money laundering rather than succumbing to the financial incentive to continue with the transaction until caught. None of the examples required the use of expensive commercial lists, daily screening of client databases for emerging PEPs or extensive reviews of source of wealth or source of funds.

None of the reports were able to:

- estimate the number of PEPs in existence, either as a base figure or by comparison to the number of 'regulated' customers or transactions processed in a year
- estimate the percentage of PEPs who, on the basis of historical evidence, are likely to pose a real risk of money laundering, rather than the hypothetical risk that all could be corrupt or corruptible
- provide numbers of cases where secondary PEPs had sought to move corruptly obtained funds on behalf of primary PEPs
- provide numbers of suspicious activity reports made relating to PEPs in the last year
- provide numbers of investigations into PEPs which were commenced in the last year
- provide any evidence that the enhanced compliance being voluntarily undertaken by some regulated persons was beyond the requirements of the Regulations actually producing improved outcomes and the extent of the benefit from those outcomes.

Despite this lack of evidence, all reports called for greater action on the part of regulated persons, to tackle the 'risk' of money laundering by PEPs.

⁶ Undue Diligence, Global Witness, March 2009
http://www.globalwitness.org/media_library_detail.php/735/en/undue_diligence_how_banks_do_business_with_corrupt

At present, it is the Society's view that there is no evidentiary-based assessment of the actual risks posed by PEPs of money laundering in the UK, to enable a proper assessment of how to effectively and proportionately tackle those risks.⁷

7.2. The legal sector experience of PEPs

In the Society's survey of AML compliance by law firms in England and Wales in the Autumn of 2008⁸, the following key findings were:

- 67% of respondents said that they did not have PEPs as clients
- Of those who had PEPs as clients, 30% were primary clients and 45% were beneficial owners of primary clients.
- The highest percentage of PEPs in a client base was 10%
- 60% of respondents were using commercial e-verifiers to help them identify PEPs
- 33% of respondents had turned down work because of the perceived risk posed by PEPs – they did not say this was because they actually suspected money laundering

7.3. Commercial providers

The current list of people who qualify as a PEP under Recommendation 9 is already very wide. It encompasses:

A person who has been entrusted with a prominent public function in a foreign country. They are:

- heads of state, heads of government, ministers and deputy or assistant ministers
- members of parliament
- members of supreme courts, of constitutional courts, or of other high-level judicial bodies whose decisions are not generally subject to further appeal, except in exceptional circumstances
- members of courts of auditors or of the boards of central banks
- ambassadors, charges d'affairs and high-ranking officers in the armed forces
- members of the administrative, management or supervisory bodies of state-owned enterprises

It also covers family members and close known associates of primary PEPs.

Because of differences in the definitions of PEPs at an international level, some commercial providers take a broader approach to the definition of PEPs while others include a wide range of persons who may pose a reputational risk to the firm for other reasons, rather than just money laundering. We understand that some commercial providers also include as PEPs all persons who are members of the ruling political party, at least in some jurisdictions. These can lead to significant over-compliance, particularly in relation to countries like China.

⁷ See also the Law Society response to the draft Transparency International report

<http://www.lawsociety.org.uk/newsandevents/topics/aml/consultations.page>

⁸ Anti-money laundering compliance by the legal profession in England and Wales, Law Society, 2009, <http://www.lawsociety.org.uk/new/documents/aml/amlcompliancereview.pdf>

In any event, because these lists predominantly rely upon publicly available information they are often incomplete in terms of the coverage of persons and the individual details contained. This can result in high levels of false-positive identification of clients as PEPs, which then requires a large amount of time to be spent checking other sources of information and seeking further evidence from clients to establish whether the client is in fact a PEP or not.

The costs of these commercial providers are also high. The Society has used its purchasing power as a representative body for the legal profession in England and Wales to negotiate better pricing for our members, so that smaller firms may be able to access these resources. However, even small firms can be spending a few hundreds of pounds a year simply to prove that they do not have a secret PEP hiding in their client base. Larger firms can find themselves spending hundreds of thousands of pounds in licence fees and thousands of pounds in search fees each year.

There is no regulation of the fees charged by these commercial providers, other than the market. In the absence of reliable evidence on the risks actually faced (that these databases are said to help mitigate) and in the face of criminal sanctions for non-compliance in some FATF countries, it is clear that the market is unlikely to be a rational or efficient regulator of such costs.

7.4. Government lists

All of the persons who fall within the definition of a primary PEP are appointed by government. In making those appointments a government will generally undertake checks on the background of those persons, both in terms of their family members and business associates and their income and assets.

The Society, our members, and others in the regulated sector, have long requested that governments should provide this information, which they are best placed to collect and retain, to the regulated sector to enable compliance with the PEP obligations.

The World Bank, in considering this request which was widely made by those financial institutions it interviewed, stated that it was neither physically possible nor politically desirable for governments to provide such lists⁹. The report did not address why it was then appropriate to pass the requirements and costs on to the regulated sector.

We appreciate that some governments around the world are actually themselves the target of these laws because of their corrupt activities within their own jurisdiction. We appreciate that such jurisdictions would be unlikely to provide such lists. However the absence of such lists would of itself flag to regulated entities that PEPs from this jurisdiction should be treated with enhanced care.

If the risk of money laundering from PEPs is as significant as government and law enforcement allege, the Society cannot understand why FATF is unwilling to call on governments to assist the regulated sector to combat this risk. In light of this unwillingness, we consider it ethically questionable to threaten private citizens with civil liability and criminal sanctions for failing to do what governments will not or cannot do.

7.5. Domestic PEPs

The consultation refers to the adoption of the United Nations Convention against Corruption and asks whether the standards should require application to domestic PEPs,

⁹ Note 3

rather than highlight this as something for member states to consider. We are strongly of the view that there should not be any extension without further clear evidence of the risks posed by domestic PEPs as an entire cohort and that this is the most effective way to mitigate that risk. It is vital to bear in mind that PEPs are also private individuals who will need to carry out day-to-day transactions many of which will be low risk. Under the United Nations Declaration of Human Rights, these persons also have the right to a private life in which to carry out those transactions. The rationale for looking more closely at foreign PEPs is that we should ask additional questions as to why the individual is doing business in another jurisdiction. However, in a more globalised world, it is not unusual for individuals generally to be undertaking transactions in other jurisdictions; even this generalisation is becoming less appropriate.

In practice, a domestic PEP will still be subject to client due diligence and ongoing monitoring, and will be the subject of suspicious activity reports where there is information which raises a suspicion of money laundering. There is no evidence that putting more names on databases and requiring management committees to scrutinise asset declarations will be likely to dramatically increase the number of such reports, in the UK at least.

While the Society appreciates that some firms will already be applying some level of enhanced due diligence to domestic PEPs, we do not believe there is sufficient evidence of unmitigated risk in this area to warrant the legislating of such voluntary practice, and the possible enforcement of it with criminal sanctions.

7.6. Family members and business associates

The consultation outlines proposals from FATF to limit enhanced due diligence on secondary PEPs only to situations where there is a direct link with the PEP in the transaction being undertaken or the product or service being utilised. The Society agrees this is likely to be a more proportionate approach. However we would like the opportunity to comment on the exact wording to better understand how it will work in practice.

8. Amendment to Recommendation 9 - reliance

8.1. Who can rely

The Society agrees with the proposals in the consultation that the decision as to who can be relied upon should remain with national governments. Each government will have a better understanding of the level of compliance and supervision within each sector, which will affect the standard and reliability of the CDD being relied upon. However, wider access to the reliance provisions is likely to promote greater use of the reliance provisions and achieve the aim of reducing red-tape. Therefore the Society suggests that the interpretive note for Recommendation 9 encourages governments to apply the reliance provisions broadly where there is appropriate compliance and supervision.

8.2. 3rd party reliance and outsourcing

The Society supports FATF's view that attempting to define the concepts of reliance, outsourcing and agency could be problematic practically and result in unintended consequences. In light of the challenges faced in obtaining CDD information, particularly for beneficial owners, it is vital that regulated entities have access to the widest range of

information sources, including other people more closely associated with the client. The Society believes that where regulated entities are still conducting their own risk assessments and reviewing the identity information themselves, they should not be restricted to only using the sources approved for complete reliance.

8.3. Intra group reliance

The Society welcomes the proposals to promote greater intra group reliance, as it recognises that is how the private sector conducts business. We believe it is important that any amendments recognise that all regulated entities, including lawyers and accountants, and accordingly be extended to designated non financial businesses.

8.4. The real problems with reliance

The Society has been supportive of the development of the reliance provisions through the European directives and in national law. The reliance provisions flow from FATF recommendation 9. The purpose of these provisions was to reduce red-tape and the costs of secondary and unnecessary CDD processes being carried out by multiple parties in the regulated sector for the same client and the same transaction. The Society and our members see these as very positive aims which have the potential to reduce the cost of unnecessary compliance which has little or no benefit in the fight against money laundering. However the specific requirements which have been placed on the use of the reliance provisions means that they cannot be used to their full capacity in practice. It is the Society's view that you cannot sensibly place responsibility (and potential sanctions) on a person for something beyond their control. As such we suggest that the proper approach is to only require a person to take reasonable steps or make reasonable enquiries before placing reliance on another person.

We understand that these concerns have been raised directly with FATF through the IBA, the CCBE and the American Bar Association (ABA) and we are supportive of the representations they have made. It is an issue which has also been made across the regulated sector within the UK. Unfortunately this key issue has not been addressed in the consultation document. As we believe the reliance provisions are of very limited use without the introduction of reasonable reliance, we feel it is important to raise them in this response.

8.4.1. Use of the provisions by law firms

In the Society's Autumn of 2008 survey¹⁰ we specifically considered the issue of reliance. We received 55 responses to the survey the key findings on reliance were as follows:

Firms who had relied on others in the UK

- 57% had relied on another solicitor
- 41% had relied on a financial institution
- 28% has relied on an external accountant
- 4% had relied on an auditor

Firms who had relied on others outside of the UK

¹⁰ Anti-money laundering compliance by the legal profession in England and Wales, Law Society, 2009, page 19 <http://www.lawsociety.org.uk/new/documents/aml/amlcomplianceview.pdf>

- 40% had relied on another independent legal professional
- 25% had relied on a financial institution
- 10% had relied on an external accountant
- 4% had relied on an auditor

Why reliance was not occurring

- 64% said they did not want to use the reliance provisions, either at all or in a more wide spread way, because of the criminal sanctions which apply to them if the other person relied upon makes an error
- 48% said they were not happy with the CDD standards being applied by others
- 34% found it difficult to assess whether equivalence applied so that they were able to use the reliance provision.
- only 48% of respondents were willing to let others rely on them - the main reason for not doing so was a concern that they would be held civilly liable for any mistakes they made

The above does not however indicate how regularly each of these firms is using reliance. In further discussions with our members, it appears that it is smaller law firms who are making greater use of the reliance provisions. In many of these cases it is because they personally know the other regulated entity they are relying upon, which is a much stricter test than envisaged by Recommendation 9. In other cases it is not clear if the smaller firms have fully considered the potential criminal and civil ramifications of the reliance provisions or the actual CDD standards of the regulated entities upon whom they are relying.

8.4.2. Variation of CDD standards

One of the key concerns is the fact that the firm who is “relying” remains liable and could face potential criminal sanctions in the event that the CDD evidence is deemed to be insufficient. In the absence of actually obtaining the documentation from the other party, it is not possible to assess whether the standard of due diligence applied will meet the expectations of the firm seeking to rely upon that party. This is largely due to the differences in the application of the risk-based approach.

A number of law firms have indicated that when documents are in fact requested, the documentation is not adequate for their purposes (leaving them concerned about criminal penalties). There are a number of reasons why the documents provided fail to meet the standards required by the party relying upon them. One reason stems from the difference in the way that the equivalence provisions are applied for the purpose of determining whether simplified due diligence applies. By way of explanation:

In the case of financial institutions, simplified due diligence can be applied to a non-EEA entity which is subject to requirements equivalent to those set out in the third directive. HM Treasury issued a list of jurisdictions for this purpose; however it included a statement that *‘firms should note that the list does not override the need for them to continue to operate risk-based procedures when dealing with customers based in an equivalent jurisdiction’*. Accordingly, the approach of simplified due diligence differs from firm to firm. Some firms completely rely on the list, while others take precautionary measures in relation

to certain jurisdictions on the list where corruption is perceived to be more prevalent. Thus the level of information held on file by firms will also differ.

Similarly, in the case of companies whose securities are listed, for the purposes of the third directive, the question is whether the entity is subject to the disclosure requirements that are 'consistent with' EU legislation. The Regulations set out a list of those disclosure requirements. On one interpretation, a firm could require all of those requirements to be faithfully reflected in the relevant market's obligations. Another firm may consider it enough to satisfy the majority of those provisions. Again this means that different approaches will be taken towards simplified due diligence.

This problem is also exacerbated by the different rules introduced in different EU jurisdictions; for example the Dutch rules require the collection of name and date of birth details for the representative of an entity. This is not required elsewhere. In the UK the relevant industry guidance only recommends obtaining the names of directors for a private company and only where it is not a well known company or there are higher levels of risk.¹¹

Even for due diligence on individuals or small businesses within the UK, the process is not straightforward. Some firms in the UK still have procedures customarily requiring passport details of directors of companies whereas others only request such information in high risk situations. Furthermore, some firms still expect to receive a utility bill dated within the last three months for individuals, even though the client may have been taken on some time before the reliance certificate is provided.

In summary, unless a firm knows that another entity has procedures that match its expectations, that firm is taking a risk in using the reliance provisions because liability remains with them. It should however be the case that a regulated person can assume that another regulated person has put sufficient procedures in place and can also rely on their risk-based judgement, unless there is evidence to the contrary.

8.4.3. Restrictions on providing material

Many law firms also now use a number of service providers for electronic verification, which often provides evidence of incorporation, registered address and director or shareholder details. All of the information obtained in this way is subject to license and therefore cannot be passed on. Accordingly this leads to gaps in the CDD documentation that can be provided to a third party. This means that if a firm relies on another regulated person, not all of the relevant information can be provided upon demand, even if it has been collected. This leaves the party relying upon them at risk of criminal sanctions and may stop other firms from providing reliance certificates.

Sometimes, even though a reliance certificate has been provided, the other party fails to supply the relevant documents upon request. As the liability remains with the party seeking to rely, there are real concerns about the position that this puts them in, i.e. at risk of criminal sanction.

¹¹ see 5.3.127 of the JMLSG guidance (Part 1) and 4.6.3 of the Law Society Practice Note

8.4.4. Civil liability

Where firms have received requests to be relied upon, many are reluctant to do so in case it gives rise to a subsequent civil claim if the risk-based judgement turns out to be misjudged. Many firms therefore seek to provide the information upfront (subject to licensing and data protection considerations).

8.5. Suggested amendments on Reliance

The Society believes the following changes to Recommendation 9 would enhance its effectiveness and applicability:

- All regulated persons should be able to reasonably rely on other regulated entities and presume that the regulated entity has in place appropriate risk-based CDD procedures, unless there is evidence which rebuts that presumption.
- Where reasonable reliance is demonstrated, the party being relied upon is responsible for carrying out CDD in accordance with its own laws and procedures and that the regulated persons relying is not liable either for its 'failure' to carry out CDD or the failings of the party relied upon.
- The party being relied upon should not be subject to any civil or other legal responsibility to the relying party.
- A reliance certificate should list the details of the evidence that has been collected and this should be sufficient for reliance. While the regulated person who is relying should be entitled to seek copies of the evidence, there should be no legal obligation on them to obtain it.
- If law enforcement wants copies of the evidence, they should make the request directly to the regulated person who is relied upon.

9. Amendment to Recommendation 1 - inclusion of tax crimes as predicate offences

The consultation outlines that FATF are considering including tax evasion in the list of predicate offences for money laundering.

The Society has a number of concerns with this suggestion which we believe need to be fully considered.

1. There is no universally accepted definition at law of tax evasion. Even in the UK this is no specific offence of tax evasion.
2. It is not clear that simply adding the offence to the list of predicate offences will be sufficient to result in money laundering offences automatically following from the predicate tax offence.
3. In the UK tax evasion type offences have been included in the money laundering regime, not simply because of the all crimes approach, but because the legislation refers to obtaining a benefit or pecuniary advantage as a result of the crime. There are a number of difficult practical consequences which flow from this definition, such as unending tainting, which may in fact not be intended by FATF.

9.1. Definition of tax evasion

There is no universally accepted definition at law of tax evasion. Traditionally, as a general approach, this concept has required an element of dishonesty and a deliberate act on the part of the individual. However in recent times there has been an increasing trend for law enforcement, government and media commentators to merge this concept with legal tax planning and minimisation in discussions on the topic.

We believe that FATF should clearly articulate the actual criminal activity and social ill they wish to target and achieve agreement as to its scope. It may be that the use of the term Fraud on the Revenue / Government is more helpful in this context.

Even by taking a clearer definition of the criminal activity, there will be challenges internationally due to the differing enactments which proscribe Fraud on the Revenue. Some countries may permit individuals and companies to structure their tax affairs in a particular manner legally, while the same conduct would not be legal in another country. For individuals and companies who operate in both jurisdictions, the foreign legal conduct would still amount to a predicate offence in the other country. As many countries have applied an extraterritorial application to their anti-money laundering laws, such individuals could find themselves reported for money laundering in one country for conduct which is legal in the country in which it is undertaken. Further, given the complexity of taxation laws, and the fact that reporting is on the basis of suspicion, very few in the regulated sector will take the time to assess whether offences are actually occurring. This is likely to see FIUs receive a significant increase in reports where there is limited prospect of a conviction, recovery of money or even useful crime fighting intelligence.

9.2. Existing international instruments on money laundering

For money laundering to occur under international instruments, you must have a predicate offence committed, property derived from the predicate offence, and then a further act dealing with that property for a specific purpose.

While we appreciate that FATF are well aware of the international instruments on money laundering, for ease of understanding our concerns, we thought it appropriate to set out some of the relevant definitions, as the exact wording is important.

Definition of property

Vienna Convention article 1 – “property means **assets** of every kind, whether corporeal or incorporeal, moveable or immovable, tangible or intangible, and legal documents or instruments which evidence title to, or interest in, such assets. “

Definition of money laundering

Vienna Convention article 3(1) – “Each party shall ... establish a criminal offence under its domestic law when committed intentionally:

- (i) the conversion or transfer of property, knowing that such a property is **derived from** [a predicate drug offence], for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of such a [predicate drug offence] to evade the legal consequences of his actions.
- (ii) the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, ownership of property, knowing that such property is **derived from** [a predicate drug offence].”

Predicate offence

While the predicate offences under the Vienna Convention related to drug offences, they were expanded under the Palermo Convention.

Palermo Convention article 6 – “Each State party shall seek to apply [the money laundering offences] to the widest range of predicate offences. Each State Party shall include as predicate offences all serious crimes as defined in article 2, and the offences established in accordance with this convention [participation in an organised criminal group, corruption and obstructing justice]. In the case of State Parties whose legislation sets out a list of specific predicate offences, they shall, at a minimum, include in such a list a comprehensive range of offences associated with organised criminal groups.

Palermo Convention article 2 - “serious crime shall mean conduct constituting an offence punishable by a maximum deprivation of liberty of at least four years or a more serious penalty.”

FATF recommendation 1 – “money laundering should be criminalised on the basis of the Vienna and the Palermo conventions. Countries should apply the crime of money laundering to all serious offences, with a view to including the widest range of predicate offences. This may include all offences or to a list of offences based on seriousness of offence or penalty. “

9.3. Applying the existing definitions to tax evasion

Effectively, under existing international instruments, fraud in most countries, including Fraud on the Revenue, could be a predicate offence for money laundering. This does not, however, automatically mean under international law that an offence of money laundering will always follow upon every Fraud on the Revenue.

Where a Fraud on the Revenue is committed by asking for a benefit, allowance or rebate to be paid, such as MTIC fraud, the individual will have derived an asset from the fraud. Further specified dealing with that asset under international law will be money laundering.

Where however the person has derived money (the asset) from legitimate income and then dishonestly failed to declare that fully to the Revenue, so that they retain the funds, it cannot be said the asset is derived from the criminal offence. What in effect has occurred is that the person has obtained a notional benefit from the offence committed, in that they have retained money to which they are no longer entitled. It would require quite a stretched interpretation of the provisions to conclude that specified dealing with the originally legitimately derived money is then money laundering.

Should FATF pursue its interest of including the latter form of Fraud on the Revenue within the ambit of money laundering predicate offences, they will need to reconsider the type of property to be covered and the actual offence of money laundering. Learning from the UK experience, such reconsideration is fraught with difficulty.

9.4. The UK experience

9.4.1. Risks for individuals

In the UK criminal property is defined in section 340 of the Proceeds of Crime Act 2002. It is an extensive definition and includes the following provisions:

Property is criminal property if it constitutes a person's benefit from criminal conduct or it represents such a benefit, in whole or in part and whether directly or indirectly.

A person benefits from conduct if he obtains property as a result of or in connection with the conduct.

If a person obtains a pecuniary advantage as a result of or in connection with conduct, he is taken to obtain as result of or in connection with the conduct a sum of money equal to the value of the pecuniary advantage.

The problem with bringing these concepts of benefit, pecuniary advantage and therefore notional property in to the offence of money laundering is that once a person has committed an offence which generates this type of criminal property, it can make it almost impossible for them ever to conduct their affairs lawfully again.

For example:

A person dishonestly fails to declare the income they received for working a second job. This amounts to £1,000 over the year in tax savings. That £1,000 represents the benefit from their Fraud on the Revenue.

They then put that £1,000 into their mortgage, increasing the equity in their home and decreasing the interest they are required to pay on that loan. The extra equity in the home and the money saved in interest are also the indirect benefit of their Fraud on the Revenue. Any re-mortgaging enabled because of the inflated value will also be the indirect benefit of the fraud.

If that extra money from saved interest enables them to buy any other asset, then that asset also becomes the indirect benefit of their fraud, in whole or in part.

If they sell the property, any increase in value or return of equity will in part also be the indirect benefit of the fraud.

Should the person then seek to correct their tax affairs, even if they pay the taxes owed and a fine, it is unlikely that they will have fully accounted for the indirect benefits accrued. As such their assets will remain tainted with criminal property.

Even if they simply leave that money in a bank account, an every day transaction out of that account will be money laundering, because all of the money is now tainted.

If you expand this example to larger scale failure to declare income for individuals or for companies, the scale of the negative consequences becomes even more apparent.

As discussed below, FATF need to consider whether such consequences are intended and are desirable in considering overall economic policy.

9.4.2. Risks for the private sector

In the consultation it is suggested that this change will only alter reporting for regulated entities and will not put them at risk of a principal money laundering offence.

The Society does not believe this will be the case. For example, in the UK, individuals can commit a principal money laundering offence on the basis that they suspect criminal property is involved, even where they have no intention to

conceal or disguise the property. Therefore in the above example, the banks and the solicitors and the estate agents would all be committing principal money laundering offences by dealing with those funds if they had any suspicion about the earlier tax evasion.

9.5. Implications for promoting inclusion in the legitimate economy

The Society believes there is a real question as to whether the secondary criminalisation through application of money laundering laws is the most effective way to reduce Fraud on the Revenue and promote the re-integration into legitimate financial markets of those who have engaged in such criminal activity in the past. This is a question which has been raised by the OECD in their 2010 paper on Offshore Voluntary Disclosure arrangements, and one which individual member states will need to carefully consider.

10. Amendment to Special Recommendation 7 – transparency of wire transfers

The inclusion of client identification information in wire transfers is of use to regulated entities in confirming client identification. However the Society appreciates that the inclusion of this data needs to be balanced with the technical challenges and costs to the financial sector.

11. Amendments to Recommendations on investigation and enforcement

The Society appreciates that these proposals are most relevant to government and law enforcement. However, we would still be interested in commenting on the detailed amendments as it is important to ensure that they adequately take into account the rule of law and human rights.

12. Usefulness of mutual evaluation reports

The Society does refer to the mutual evaluation reports to assist us in providing advice to the legal profession on jurisdictional risk and equivalence. At present they are too dense, too infrequent, provide limited statistics. We are greatly in favour of the approach taken by Moneyval, requiring yearly updates from member states particularly the statistical information on suspicious activity reports and assets seized as a result.

The Society also finds the existing ratings lacking in transparency and appear to have been “agreed” suggesting that there may have been some form of political intervention in finalising the report. While the FATF methodology guidance provides that mere legislative transposition is insufficient for achievement of a ‘compliant’ rating, our members practical experience in some countries is not always consistent with the ratings awarded. Further, there is no recognition in the ratings that where member states have gold plated the standards this may in some cases result in a less effective regime.

While we appreciate that there is an extensive methodology guide for assessors, this is not practically usable for the private sector in their day to day compliance. We would like to see greater clarity in the ratings and the basis on which they were awarded on the face of the report, to better assist firms to assess risks and equivalence.

