



The Law Society

## **Draft money laundering regulations 2007**

**The Law Society's response  
30 March 2007**

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## Introduction

This response has been prepared by the Law Society, the representative body for over 100,000 solicitors in England and Wales. The Law Society negotiates on behalf of the profession and lobbies regulators, government and others.

The Law Society welcomes the opportunity to comment on the draft Money Laundering Regulations 2007 (the draft regulations). The Law Society is committed to ensuring that anti-money laundering measures are workable and effective. In order to achieve this aim the draft regulations must be clear and proportionate. We are also concerned that a level playing field is achieved with regard to implementation throughout the EU, so that legal practitioners and other business in the UK do not lose crucial parts of their business to other EU jurisdictions.

The Law Society has long supported the risk-based approach of implementing money laundering obligations under the Third European Money Laundering Directive (the directive). It considers that this approach encourages practitioners to undertake bespoke risk assessments of their businesses, services and clients, enabling them to implement systems and controls that match the specific risks of their business. However, in order for the risk based approach to operate effectively in practice, it is essential that mandatory requirements should not be set too high along the scale of risk.

The Law Society remains committed to advocating for regulations which are clear in law and proportionate to the identified risks. This response incorporates a number of proposals which the Law Society believes will assist in meeting such an objective.

This response is in two parts, Part 1 covers the concerns held by members of the Law Society, while Part 2 responds to the specific questions asked in the consultation document. The response has been informed generally by discussions with firms, meetings of our Money Laundering Reporting Officers' Groups, and comments posted on our anti-money laundering discussion forum. Specific issues raised in this response have been canvassed:

- with members through a web-based campaign to which 485 firms have signed up in support, many providing their views on the impact of the draft regulations on their firms;
- through a discussion forum for city firms attended by representatives from Allen & Overy, Ashurst, CMS Cameron McKenna, DLA Piper Rudnick Gray, Freshfields Bruckhaus Derringer, Herbert Smith, Linklaters, Pinsent Masons, Slaughter & May, and Withers;
- with members of the Law Society's Money Laundering Taskforce, which includes representatives from Burton Copeland, Byrne & Partners, Eversheds, Herbert Smith, Irwin Mitchell, Kingsley Napley, Lovells, and Simmons & Simmons; and
- with representatives of STEP.

The Law Society has also considered the consultation responses from Slaughter and May; Clifford Chance; The City of London Law Society; the Association of Pension Lawyers; and the December 2006 position paper from the Financial Markets Law Committee. The Law Society broadly endorses the representations made in those responses.

## Part 1 - Concerns held by Law Society and its members

### Customer Due Diligence (CDD) Requirements

#### 1 Beneficial ownership

Since 2004, the Law Society has been highlighting the difficulties likely to be encountered when framing a definition of beneficial ownership particularly within a UK trust context. Our arguments as to the significant difficulties are already contained in the following enclosures:

- A. Law Society Response to Consultation – November 2004
- B. Law Society Response to Consultation – October 2006
- C. Joint STEP / Law Society Position Paper – November 2006
- D. Law Society Letter to Mr Stephen Timms MP – January 2007
- E. Law Society Letter to Mr Ed Balls MP – February 2007

We have since obtained an opinion from Rabinder Singh QC and Alex Bailin of Matrix Chambers confirming that the current definition of beneficial ownership in the draft regulations is so uncertain that the associated criminal offences in the regulations do not meet the community law, common law and ECHR requirements of legal certainty. A copy of that opinion is at *enclosure F*.

There are four key areas of practice where the definition of beneficial ownership is quite critical:

#### Trusts

Trusts are a unique creation of UK law, where a beneficiary is not by definition a beneficial owner. By changing this fundamental tenet of trust law for the purposes of anti-money laundering regulations, a new, self-contained definition must be clearly provided in the draft regulations to make this section workable.

##### Defined beneficiary with a 25% interest

The Law Society is of the view that the only way to provide clarity as to who is a defined beneficiary, is to limit this to a named person with a vested and indefeasible interest in the trust property. While those terms may not be readily understood by lay persons, they do have a settled meaning in law. That settled meaning can be explained in industry guidance. Limiting a defined beneficiary in this manner means that resources will be efficiently deployed to consider money laundering risks only in relation to those persons who are certain or almost certain to actually receive property.

##### Interest in income

Trust property is clearly understood in trust law to mean the property is held by the trust. Trust income is clearly understood to mean income derived from trust property, which is treated separately from trust property, until such time as it is re-invested in the trust property. It does not become trust property if it is paid out to a beneficiary. If Treasury are of the view that income should be included as trust property, this will need to be made clear in the regulations.

***The Law Society recommends that income should not be included as trust property*** for the following reasons:

- When a trust is created, regulated parties involved in its creation should be ascertaining the source of funds and ensuring that they are not criminal property. If the funds are “clean” when they go into the trust, any income generated from them cannot be the proceeds of crime, unless the trustees engage in criminal activity to generate the income.
- If the trustees themselves are engaging in criminal activity, it is by conducting CDD on the trustees and understanding their activities which will thwart money laundering, not identifying the beneficiaries of income.
- The inclusion of income into the trust property makes it very difficult to ascertain what amounts to a 25% interest. Would it only mean 25% of the income for the year or for the intended lifetime of the trust? Is that estimated or actual income? Or does it mean 25% of the total trust property including income for the year or the intended life time of the trust? This lack of clarity would make application of the requirements particularly difficult for trusts administering estates or providing charitable grants.

#### Positive control only

The Law Society has previously indicated its view that control is crucial to anti-money laundering measures with respect to trusts. It is where positive control is exercised, such as deciding to make an investment or deciding to make payment to an individual, that money laundering becomes a possibility. Negative control, such as disallowing a payment or an investment does not facilitate money laundering. ***As such, it is recommended that only those with positive control over trust property be defined as having control.***

It is noted that there are certain rare cases where, if all beneficiaries are absolutely entitled to property and are of age, they may seek to dismiss all of the trustees and appoint new trustees. Even if this was to occur, the original trustees would have to give notice of their resignation and all new trustees would have to be subject to identification themselves. This level of exposure would make it an unlikely way of putting criminal associates in control of property to facilitate future money laundering through the trust.

***The Law Society recommends that it should be clear that the individual must be able to independently control 25% of the trust property, rather than to do so collectively.***

#### **LLP's**

Limited Liability Partnerships are another unique creation of UK law. Their structure is a mixture of both company and partnership attributes. It is not currently clear which part of the definition of beneficial ownership they would fall under.

***Accordingly, the Law Society seeks clear direction in the regulations as to what procedures apply to a LLP when considering beneficial ownership.***

## **Corporate entities**

The Law Society is pleased to note that if a beneficial owner of a corporate entity is another entity listed on a regulated market, then further checks to ascertain the natural persons who own 25% of that entity's shares are not required. However, it would be of even greater assistance if the Treasury would provide an indication of which markets it considers to be regulated with disclosure requirements consistent with community legislation or equivalent international standards.

However, the current definition poses significant difficulties for private companies, particularly from other jurisdictions where the provision of investor's details is not the norm. Regulated persons will be required to rely on the provision of information from the corporate entity itself. While it is noted that regulation 4(1)(b) does not require independent verification of the identity of a beneficial owner, it does require verification on some level. It is not clear how this is to be achieved.

The Law Society agrees with the City of London Law Society's concerns that the definition of shares and voting rights are too general and simplistic to take into account the different classes of share ownership and voting rights often utilised in modern company structures.

Similarly, the requirement to ascertain individuals who otherwise exercise control over the management of the corporate entity is quite imprecise. Would that include the auditors, any industry regulators, or the customers? These may seem extreme examples but one would only have to look to recent press to find instances of the management direction of a company being changed to accommodate any of these stakeholders.

***The Law Society requests that these issues be clarified.***

## **Collective investment schemes**

Collective investment schemes often utilise trusts or partnerships to hold investment assets. Our members have raised two specific collective investment schemes which will be negatively impacted by the draft regulations. However, it is likely that these concerns will translate to other such investments.

### Private equity funds

Treasury estimated this year that approximately £7 billion worth of UK assets are currently under management by private equity funds. This figure does not take into account the value of foreign assets managed by UK based private equity funds, nor the value of payments for services by private equity funds to UK professionals, such as accountants and lawyers.

Private equity funds are highly mobile entities, which will re-deploy into markets with the best overall conditions for their activities. Such funds generally see their investor lists as trade secrets and so are not amenable to disclosing details to others, particularly others who may be in a position to encourage their investors to move into other products. Further, investors themselves may have commercial reasons for not wanting others to know that they are involved in activist investment, particularly where they hold

competing interests in other businesses.

Under the draft regulations a fund manager will be required to disclose full details of all the investors and their holdings in the fund, and at times allow access directly to some investors to obtain identification documents, every time they want to:

- open a bank account
- seek taxation advice
- have their account's audited or
- sell or purchase a property.

Such requirements may be seen to be more of an intrusion into the running of such funds than other benefits from the UK market warrant. This in turn may lead to private equity funds re-locating to other jurisdictions where such requirements do not exist. Given that the UK will be among the first countries to implement the directive, if the consequences as predicted in this and other submissions materialise to the degree foreshadowed, other countries may choose to take a softer approach in this area in a bid to attract more business from private equity firms.

The nature of a private equity firm is that it requires a large investment for many years, with a significant risk that all of the investment capital may be lost. This is not the type of vehicle which money launderers would be likely to find attractive, nor is there any evidence that they have made use of such investment opportunities to launder funds in the past.

Our membership have suggested a number of ways to reduce the negative effects of the need to identify beneficial owners within the private equity sector, these include:

- allowing simplified due diligence; or
- allowing reliance on the fund manager to certify that beneficial owners have been appropriately identified.

***The Law Society recommends that the Treasury undertake a regulatory impact assessment on how the need to identify beneficial owners is likely to impact the private equity sector particularly, and other collective investment schemes generally. The Law Society recommends that provision be made in the draft regulations which will minimise this impact.***

#### Pension funds

Two key issues arise out of the need to identify beneficial owners for a pension fund.

The current regulations allow for simplified due diligence where an occupational pension scheme's rules do not permit assignment of a members interest. There are however two UK statutory provisions which require assignment to take place in limited circumstances. As such most pension rules permit assignment to comply with those two provisions and would therefore not come within the simplified due diligence provisions.

***The Law Society recommends that regulations 9 (7)(c) be amended to include the words:***

***“except as permitted by or pursuant to any provisions of sections 91 to 94 of the Pensions Act 1995 or section 44 of the Welfare Reform and Pensions Act 1999.”***

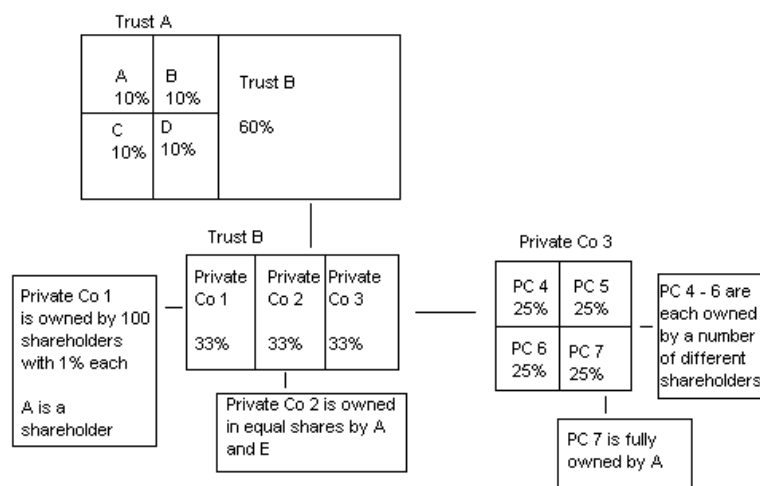
The other concern with respect to a pension fund is the element of control in the definition of beneficial owner. It is noted that in many pension funds, the individual contributors can direct that their own contributions are invested in particular types of investments. While each individual contributor is unlikely to have contributed more than 25% of the funds in the pension fund, all of the contributors collectively have the ability to control the manner in which 100% of the funds are invested. If the test for control was considered to be satisfied in these circumstances, it would be disproportionate to the risks posed, as it is likely that money launderers would prefer their activities to be undertaken within a very small trusted group rather than trying to facilitate collective action with a number of other individuals over whom they have no control.

***The Law Society recommends that it be made clear that the individual must be able to independently control 25% of the trust property, rather than collectively.***

### Cross holdings

In many instances where a corporate entity or other legal entity or arrangement is utilised, the owners of that entity or arrangement will not necessarily be natural persons themselves. For many legitimate reasons, entities and arrangements will invest in other entities and arrangements. It may take some layers before it is possible to establish natural individuals who have an interest in an entity or arrangement.

Take the following example:



For the purposes of the above example, entities A to E are natural persons. In this example, Person A, through various holdings in subsidiaries has a 25.08% interest in Trust B. Because of the 60% interest that Trust B has in Trust A, this means that A has a 15.048% interest in Trust A through Trust B and a direct 10% interest in Trust A. This means that A has a total interest of 25.048% in Trust A, and so customer due diligence should be conducted on A.



However, if A did not have a holding in any of the subsidiaries, or if the percentages were changed even slightly, then there would actually not be any individual natural person who had a 25% interest in Trust A.

The problem is that under current drafting, until the natural person is identified at the end of each corporate structure, it is not possible to know whether any individual has a 25% interest in the initial structure.

The Law Society's view is that this approach is disproportionate for the following reasons:

- As outlined in the diagram above, where a 25% interest is not held directly, but through various levels of intermediaries, there is much less of an opportunity to influence the investment and payment decisions of the initial entity, as this would necessitate convincing the boards of directors or trustees of the intermediaries to fully represent your views at each level. The wider the requirement for complicity in criminal activity the greater the risk of exposure, and the less likely it is to occur.
- Where directors or trustees are engaging in money laundering, either independently or on behalf of owners or beneficiaries, it is by understanding the transactions being undertaken and the reasons for the structure and control of the entity that a greater understanding of money laundering risks can be ascertained. If too much emphasis and too many resources are diverted to the minutiae of identification and verification, this will detract from the focus on the big picture issues of the transaction and overall structure and control.

As the regulations are intended to be risk based, mandatory requirements should be appropriate in scale. Accordingly, once a beneficial owner with a 25% interest is identified, the requirement for identification should be deemed to have been met, whether that beneficial owner is a natural person or another legal entity.

At that point appropriate CDD for a corporate or legal entity should be undertaken. This would still require ascertaining who the company directors or the trustees are and understanding the overall corporate structure. Should the regulated person have concerns with respect to money laundering, either because of the nature of the transactions or the manner in which instructions are being provided, they may then seek further information to better understand the ownership and control structure of their client as required by draft regulation 4.

***The Law Society recommends that for the purposes of the definition of beneficial owner, an individual should be defined to include a body corporate, legal entity or arrangement.***

### **Beneficial Ownership – suggested drafting**

Accordingly, the Law Society recommends the following re-drafting of the definition of beneficial interest in order to ensure clarity and resolve the unworkability of the current definition, and to take account of the main problems identified regarding the current definition, although as outlined above the definition for corporate entities requires further consideration.

### **New Regulation 3**

**Subject to the following subsections, 'beneficial owner' for the purpose of these regulations only, means the individual(s) who ultimately owns or controls the customer or on whose behalf a transaction or activity is being conducted.**

- 1. In the case of a body corporate, the beneficial owner is deemed to be any individual who –**

***[further consideration needs to be given to the particulars in light of the concerns raised above]***

- 2. In the case of a legal entity or an arrangement other than a trust which administers and distributes funds, the beneficial owner shall be deemed to be:**
  - a. any individual who is entitled to at least 25% of the property of the entity or arrangement;**
  - b. in respect of any property of the entity or arrangement, in which no individual who has an interest has been determined, the class or classes of persons in whose interest the entity or arrangement operates; and**
  - c. an individual who on his own controls at least 25% of the property of the arrangement.**
- 3. In the case of an arrangement which is a trust, the beneficial owner shall be deemed to be:**
  - a. any individual who is entitled to a vested and indefeasible interest in at least 25% of the capital of the arrangement;**
  - b. in respect of any property not subject to a vested and indefeasible interest, the class or classes of persons in whose interest the entity or arrangement operates; and**
  - c. an individual who on his own controls at least 25% of the property of the arrangement.**
- 4. The following person (and no other) should be treated as satisfying the requirements of regulation 3(3)(c):**

**Any person who has the power presently exercisable (and whether or not jointly with, or subject to the consent of, some other person):**

  - a. to dispose of the property in favour of themselves or some other person; or**
  - b. to vary the trust(s) applying to the property; or**
  - c. to require the sale or to direct the investment of the property.**
- 5. As to estates in the course of administration, in applying Regulation 3(3):**
  - a. The interests of creditors should be disregarded;**
  - b. The net amount of the estate (if any) for distribution to beneficiaries and the impact of the incidence of debts as**

***regards the value of beneficial interest shall be such as the personal representative(s) shall estimate to be likely to be the position at the conclusion of the administration;***

***c. It shall be assumed that the administration of the estate is complete.***

***6. For the purposes of Regulation 3, individual means: an individual, body corporate, legal entity or an arrangement such as a trust.***

## **Guidance**

Until now, Treasury has said that the lack of clarity in the definition of beneficial ownership can be dealt with by guidance. However, not only does the Law Society consider it unacceptable of the government to pass the burden of interpreting the opaque language of the directive onto practitioners, Rabinder Singh QC and Alex Bailin make clear that, due to the ambiguity in the definition of beneficial owner in the Regulations, any guidance would be taking the place of legislation and would accordingly be unconstitutional. Counsel's view would be unaltered even if the guidance were drafted by the Law Society and approved by the Treasury.<sup>1</sup>

## **2 Reliance**

Article 16 of the directive provides that a regulated person may rely on other persons listed in Article 2, or equivalent persons in a third country who meet certain requirements, for completion of customer due diligence checks. Article 15 permits reliance even if different documents have been used to those required in the member state to which a customer is being referred.

However, draft regulation 12 requires that persons listed in Article 2 of the directive must also comply with the requirements listed for a third country, but makes no reference to the use of different documents as permitted in Article 15.

We are concerned that the failure to transpose this provision into the draft regulations will have a significant impact on the value of the reliance on third parties provision.

The draft regulations are written in a manner which requires certain questions of fact to be answered by a regulated person before they can rely on a third party. To answer those questions of fact, a regulated person will need to take the following steps:

For a third party in the UK

- ascertain by which supervisory authority the other regulated third party is supervised; and
- contact the supervising authority and ascertain whether the regulated third party is on their register for the purposes of money laundering regulation.

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<sup>1</sup> Para 48, Opinion 26 March 2007 – See Enclosure F

For a third party in an EEA state

- check whether the directive has been incorporated into the domestic law of the specific EEA state;
- decide whether the implementation provides for supervision in the way contemplated by the directive;
- ascertain whether the specific EEA state has mandatory professional registration recognised by law for the category of person or firm on which they wish to rely; and
- contact the supervisory authority to ascertain whether the actual person or firm is subject to such registration and supervision.

The draft regulations are intended to be risk based. This means that they should be set at an appropriate standard for compliance in a low risk environment, with individuals able to take further steps to counter increased risk situations. For example, if a regulated person has a long standing business relationship with another firm, whether they are lawyers or accountants or a financial institution, they are more likely to simply ask questions about the actual CDD conducted to ensure it is of a standard that they are willing to accept, given that the final responsibility lies with them. On the other hand, if the third party is a smaller firm, with whom there has been no previous interaction, a regulated person will be more likely to ask more questions about the standards to which they operate and conduct searches on the firm to see if they are registered with the appropriate authorities, or to conduct an internet search to see if they have had negative press, disciplinary action or other legal proceedings which would make them less suitable for reliance.

The Law Society is concerned that the regulations as currently drafted set the standard too high for a normal low risk situation, and will therefore not be of great assistance to firms in minimising cost and time spent on conducting CDD. Regulation 12(1) makes it clear that any such reliance should be risk based. If the law is clear, firms can be assisted in appropriately addressing different levels of risk which would attach to reliance in different circumstances, through industry guidance.

Our members are concerned that the failure by the UK to have a specific statement of mutual recognition for documents in line with Article 15 may have a detrimental impact on other member states being willing to allow mutual recognition with the UK. Further, where Treasury approved guidance states that identification on the basis of certain types of documents, or documents which include certain information, is best practice, there is a concern among members that if they accept CDD by a third party from another country on different documents, they may not receive the full benefit of any protection offered by compliance with the guidance in a future prosecution. As such it would be preferred that such mutual recognition is made explicit.

The Law Society recommends the following drafting for regulation 12(2):

- 2. For the purposes of this regulation, “third party” means –**
- a. UK credit or financial institution;**

- b. a relevant person in the UK who is an auditor, external accountant, insolvency practitioner, tax advisor, notary or other independent legal professional;**
- c. a person who carries on business in another EEA State who is a credit or financial institution, an auditor, external accountant, insolvency practitioner, tax advisor, notary or other independent legal professional; and**
- d. a person who carries on business in a non-EEA State who is**
  - i. a credit or financial institution, an auditor, external accountant, insolvency practitioner, tax advisor, notary or other professional;**
  - ii. subject to mandatory professional registration recognised by law;**
  - iii. subject to requirements equivalent to those laid down in the money laundering directive; and**
  - iv. supervised for compliance with those requirements in a manner equivalent to section 2 of Chapter V of the money laundering directive.**

The Law Society recommends adding a further subsection in regulation 12 which provides:

***Where a relevant person intends to rely on a third party in accordance with (1), the relevant person may so rely even if the documents or data on which the customer identification has been based are different from those required in the UK.***

### **3 Reliance on branch offices**

Solicitors have particularly expressed frustration that despite due diligence having been performed in one country, if a branch office in another country becomes involved in the transaction, the second office is required to complete the due diligence process again. If, despite the Law Society's representations at point 2 of this response, reliance is not to be permitted where a country has not implemented the directive or similar requirements in a non-EEA state, then the reliance provisions are of no use to resolve this problem.

The Law Society notes a suggestion by Treasury during the consultation that the ability to outsource CDD requirements contained in regulation 12(5) may be a way around this problem.

***The Law Society requests that the draft regulations make it clear that, where another branch office has conducted CDD to a standard compatible with the third directive, the relevant person in the UK may rely on that CDD. The Law Society is of the view that this could either be achieved through an express statement in regulation 12(5) or a separate provision.***

#### **4 CDD on existing customers**

The Money Laundering Regulations 2003 (2003 regulations) provided that solicitors did not need to conduct client identification where business relationships had formed before 1 March 2004, except if there was a suspicion of money laundering.

This exemption has not been included in the draft regulations. Instead draft regulation 5(2) provides that regulated persons must apply customer due diligence measures at appropriate times to existing customers on a risk-sensitive basis.

From consultation with the profession, it is estimated that for most firms the majority of their customer base existing prior to 1 March 2004 have not been subjected to CDD procedures, because of the long standing relationship of trust they have with these clients.

A solicitor is required under professional rules not to engage in activities which will bring the profession into disrepute. As such, (leaving aside the access to justice requirements for criminal lawyers) solicitors are selective with respect to the clients with whom they are willing to continue a professional relationship with. Professional relationships are not maintained where it is considered that there is a reputational risk for the individual solicitor or the firm due to suspicions of money laundering. For those rare solicitors who choose to knowingly assist clients with money laundering, requiring them to obtain a copy of the client's passport and recent gas bill to establish their identity will not stop them engaging in such activities.

The professional relationship between solicitor and client is one of trust, and where that trust has been established, solicitors act for their clients over a period of years. It is not uncommon for established corporations to have retained the same firm or group of firms for a hundred years or more, while families tend to retain the same local solicitors firm for generations. Solicitors rely on their knowledge of the client, built up over years of the professional relationship, to be satisfied that they know who their client is and that the particular client does not pose a reputational risk to the firm. To require solicitors to now ask those clients to prove that they are who they have always said they were, infringes on that relationship of trust and is of no benefit in the fight against crime. Indeed, it requires resources which could be better targeted dealing with other areas of more significant risk.

The draft regulations do not provide any clarity with respect to what is an appropriate risk-sensitive basis for conducting CDD on existing clients. Does this mean only when the solicitor develops a reason to be concerned about the existing client; or whenever an existing client commences a new transaction covered by the draft regulations? For a corporate client, is the requirement triggered when there is a change in shareholding or a change in the board of directors? Is the test of appropriateness and the level of risk a subjective or an objective standard?

While a solicitor will often update their knowledge of a client with each set of new instructions they receive, this is significantly different from the CDD requirements under the draft regulations. CDD under the draft regulations ultimately requires evidence of identity, such as copies of passports and gas bills for one or more individuals, with possible checks conducted on independent databases and

directories to confirm the information received.

The resources required to comply with the new requirements will be extensive. The whole point of the CDD requirements is to ensure that financial institutions and professionals know who their customer is. As such, the requirements envisaged by the current draft regulations are quite disproportionate to the risk posed where a solicitor has been acting for a client for years and is satisfied that he knows the client.

Accordingly, the Law Society recommends that regulation 5(2) should be drafted in the following manner:

***Relevant persons should apply customer due diligence to existing customers if:***

- a) there is a suspicion of money laundering or terrorist financing with respect to the existing client; or***
- b) there are doubts about the existing client's identity as presented to the relevant person previously.***

This recommendation is made on the basis that the Law Society considers that these are the appropriate and risk-based events which lead to a proportionate approach to conducting CDD on existing customers.

There will also need to be a definition of existing customer included in regulation 2. This should be in accordance with the 2003 regulations.

## **5 Home information packs (HIPs)**

On the reading of the draft regulations, it would appear that if a solicitor simply agrees to undertake preparation of a HIP, they will be required to conduct CDD prior to commencing that work. The Law Society considers that the money laundering risks at this point are non-existent, as this is mere information gathering preparatory to marketing, not preparing for the actual transfer of property. CDD checks should not therefore be required. It is when a solicitor is instructed in the property transaction that money laundering risks can arise and CDD is relevant.

There are two other likely providers of HIPs, namely real estate agents and independent HIP providers. A real estate agent is covered by the draft regulations. Section 1 of the Estate Agents Act 1979 provides that estate agency work relevantly means:

“things done in the course of a business, pursuant to instructions received from a person who wishes to dispose of or acquire an interest in land for the purpose of, or with a view to, effecting the introduction of that person to a third person who wishes to acquire or dispose of a such an interest.”

While it is clear that advertising a property for sale would amount to doing a thing with a view to introducing a seller and a buyer, it is not clear whether preparing a HIP would similarly be covered. It is arguable that producing a HIP only, is done with a view to allowing a later introduction to proceed legally to the conveyance of the property, rather than with a view to effecting the introduction.

Further, given that the draft regulations are defined by profession rather than activities, it is even less clear whether a person or business simply providing HIPs would be required to comply with the money laundering regulations.

Accordingly, in light of the possible competition issues between different providers of HIPs and the non-existent money laundering risk posed where a regulated person is merely providing a HIP to a client:

***The Law Society recommends that the provision of HIPs should be specifically excluded from the regulations.***

## **6 Politically exposed persons (PEPs)**

The Law Society has long advocated a proportionate approach towards the requirements for identifying PEPs. Our main concerns as set out in previous submissions regarding the directive and its implementation were that the requirements for risk-based procedures could force firms to invest in expensive software applications even where the size of their businesses and their exposure to PEP-risk would not warrant this type of investment. We highlighted the fact that the composition of our membership is such that 84.7% of firms consist of fewer than 4 partners and only 1.6% of firms have over 26 partners. Many of those firms will rarely, if ever, deal with potential PEPs, therefore the cost of mitigating this slight risk must be proportionate.

The draft regulations provide that when dealing with a politically exposed person a solicitor must:

1. have appropriate risk-based procedures to determine whether the customer is a politically exposed person;
2. have senior management approval for establishing a business relationship with such a person;
3. take adequate measures to establish the source of wealth and source of funds which are involved; and
4. conduct enhanced ongoing monitoring of the business relationship.

PEPs are defined as individuals who have been entrusted with a public function at a national level around the world or in international bodies, their immediate families and known close associates. When ascertaining whether a person is a known close associate, a relevant person must have regard to any information which is in his possession or is publicly known.

While a new client could be asked a simple question at the start of a business relationship as to whether they are a politically exposed person, the emphasis throughout the draft regulations is on recourse to independent data and publicly known information, which strongly suggests that this will not be sufficient for identification, let alone verification.

If a person tells you that they are not a politically exposed person, it is then difficult to know where, other than a commercial database, one would start to look for information to confirm or deny this representation from the client.

While most national parliaments keep a list of their members and their members interests, in which you would hope to find details of anyone who qualifies as a



close business associate, these may only be accessible in print version in the relevant jurisdiction, rather than on-line. These documents are a part of the public record and accordingly the information in them is publicly known, however it does not mean that a lawyer in the UK will be aware of it or be able to access that information.

For other agencies, such as courts, armed forces, central banks and state run agencies, while there may be a list of individuals involved in senior management available electronically, registers of interests and details of their family members are often not available electronically, and may or may not be published otherwise.

Another point of possible difficulty is where immediate family members do not have the same name as the primary PEP. While published profiles for public people often list whether they are married or have children, they do not often name them, mainly due to privacy or security concerns, rather than a desire to enable them to launder money.

As stated above, just because information is publicly available, and even circulated to varying degrees within the public domain, it does not mean that it will be known of or readily available to a solicitor or any other regulated person conducting CDD checks.

The Law Society considers that it is incumbent upon the government to provide information to the regulated sector which enables them to comply with the obligations regarding PEPs. It is inappropriate to pass the cost of attempting to conduct verification themselves or purchasing access to expensive commercial databases, onto individual regulated persons. Nor is it appropriate for industry regulators to be forced to attempt to provide details of PEPs to their members free of charge, particularly as the information required is far more readily and accurately available to government through its diplomatic connections, than to most individuals or agencies.

***The Law Society recommends that the government commit to providing to regulated persons a free database to identify PEPs.***

## **7 Exemptions for issuers of financial instruments**

The directive at paragraph 13 of the preamble sets out that trust relationships are widely used in commercial products as an internationally recognised feature of the comprehensively supervised wholesale financial markets. An obligation to identify the beneficial owner does not arise from the fact alone that there is a trust relationship in this particular case.

The draft regulations at 5(4) only exempt the trustee appointed by the issuer of certain instruments or securities from conducting CDD on beneficial owners.

London is a very innovative financial market, with the Global Financial Centres Index currently ranking London as the most competitive financial market in the world. City law firms and the Financial Markets Law Committee have specifically made representations to the Law Society that the exemption in regulation 5(4) should be drafted as widely as possible to ensure that the development of new and innovative financial products is not restricted due to the need to convince government to include such products within the list of exempted instruments.

There is a further concern that the government has gold-plated this exemption by limiting the simplified due diligence only to the trustee, whereas the directive provides the exemption to the transaction as a whole.

Accordingly, the Law Society recommends that the regulation should be redrafted in the following manner:

#### **Regulation 5**

***(4) An arrangement such as a trust, for the purposes of the definition of beneficial owner in these regulations, is not created where a trustee is appointed by the issuer of commercial products in a wholesale financial market as trustee for the issue of such commercial products.***

***(5) Where transactions with respect to commercial products referred to in regulation 5(4) are undertaken, there is no requirement to apply customer due diligence measures referred to in regulation 4(1)(b) in respect of the holders of such commercial products.***

#### **Administration**

##### **8 Record keeping**

The directive in Article 30 provides that the following records must be kept:

- a. in the case of customer due diligence, a copy or the references of the evidence required, for a period of at least five years after the business relationship with their customer has ended; and
- b. in the case of business relations and transactions, the supporting evidence and records, consisting of the original documents or copies admissible in court proceedings under the applicable national legislation for a period of at least five years following the carrying out of the transactions or the end of the business relationship.

This appears to require that documents demonstrating the business relationship should be retained for five years after the end of the business relationship. However, all supporting documents for individual transactions undertaken during that business relationship only need to be retained for five years after the transaction has been completed. This interpretation of the directive coincides with the views expressed by the Joint Money Laundering Steering Group's guidance in Chapter 9, which has been approved by Treasury. It is also compliant with FATF's recommendation 10 on money laundering.

The current drafting of regulation 13 goes beyond these obligations and requires that where a firm has an on-going relationship with a client, they must wait until five years after the business relationship ends before any documents relating to any transaction undertaken during that business relationship can be destroyed.

Smaller firms may have a business relationship with an individual for decades while some large companies may have the same firm of solicitors for 100 years or more. The resources required to maintain such archives of transaction records are enormous and wholly disproportionate to the benefits.

The Law Society considers this to be gold-plating of the record keeping requirements, which places an unnecessary and disproportionate burden on solicitors' and other persons subject to the regulations.

Accordingly, the Law Society recommends the following amendment to the drafting of regulation 13 (3):

***For customer identity information and records evidencing the business relationship, the period is five years beginning on the date on which the business relationship ends.***

***For records evidencing each transaction, the period is five years beginning on the date on which the transaction is completed.***

## **Reporting**

### **9 Suspicious activity reports (SARs)**

Now that SOCA has ensured that the SARS regime is operating more effectively, it is important that the reporting sector receives comprehensive and reliable statistics, which have not previously been available. The development of easily accessible typologies would also be of assistance to practitioners.

The provision of this information will assist solicitors and other regulated persons to be more effective in their compliance and enable that compliance to be of greater value in combating money laundering and terrorist financing.

Article 28 of the directive permits independent legal professionals to advise other independent legal professionals who are subject to professional secrecy and data protection obligations, whether they are in the UK or overseas, that a SARs has been made with respect to a client, for the purposes of prevention of money laundering and terrorist financing.

This aspect of the directive has not been transposed either through these regulations or an amendment to Proceeds of Crime Act 2002. The ability to share this information will be significantly useful to lawyers, and if it is not transposed it may have negative ramifications in cross-border transactions with other EU countries.

***The Law Society recommends that Article 28 be implemented in the UK.***

## **Supervision**

### **10 Supervisory authority**

The Law Society confirms that "The Law Society" is the correct name of the professional body for solicitors to be included as the supervisory authority within the draft regulations.

## Enforcement / Offences

### 11 Enforcement powers

Regulations 30 to 36 grant a number of powers to the HMRC, FSA and OFT. These powers are to be exercised by the 'supervisory authority' with respect to a 'relevant person'. The use of these powers is limited to situations where they are being utilised by the supervisory authority in respect of their functions under the regulations.

However, these three agencies have supervisory functions under regulation 17 and prosecutorial functions under regulation 42. The fact that the powers sit under a separate Part entitled 'enforcement' and are co-located with regulation 42, rather than being located under the Part entitled 'supervision and registration'; adds to a lack of clarity as to whether these are supervisory powers or enforcement powers which can be utilised against all relevant persons.

The Law Society notes that Treasury indicated during the consultation that these powers were intended to be supervisory powers exercisable only against those regulated persons who are supervised by the HMRC, FSA or OFT. While regulations 30 to 36 could be re-drafted entirely to create better clarity, sufficient clarity may be achieved if the powers are limited to the 'supervisory functions under the regulations'.

It is also noted that in the 2003 regulations, where HMRC had the power to enter a premises with a warrant, there were a number of protective measures attached to the power, such as the requirement to provide the occupier of the premises with a copy of the warrant and that searches of females should only be conducted by other females. We can see no good reason why these protective measures have not been included in the draft regulations.

***The Law Society is concerned at the lack of reference to legal professional privilege, in draft regulations 32 and 33. We seek clarity as to whether legal professional privilege is to apply to the exercise of those powers.***

### 12 General and vague offences

The draft regulations contain two new requirements for regulated persons to be generally aware of money laundering and terrorist financing risks.

These are:

Regulation 11(5) which provides: All relevant persons must pay special attention to any money laundering or terrorist financing threat that may arise from products or transactions that might favour anonymity and take measures, if needed, to prevent their use for money laundering or terrorist financing purposes.

Regulation 14(1)(b) which provides: A relevant person must pay special attention to any activity which he regards as particularly likely, by its nature, to be related to money laundering or terrorist financing and, in particular, complex or unusually large transactions and all unusual patterns of transactions which have no apparent economic or visible lawful purpose.

Non compliance with either of these sections may result in prosecution and, upon conviction, possible imprisonment of up to two years.

We appreciate that money launderers and terrorist financiers are innovative and respond flexibly to counter new areas of regulation and that solicitors and other regulated persons may be well placed to identify new developments in money laundering and terrorist financing in their particular areas of practice. However, it will often be the case that supervisory authorities and law enforcement agencies are better placed to consider the various individual cases of a new methodology reported to them, understand trends developing in this area, and provide that crystallised information back to regulated persons to assist them to develop better systems.

As such, the Law Society agrees that it is important to remind persons covered by the regulations that money laundering and terrorist financing are dynamic crimes and they should remain alert to changes in methodology and adapt their systems to counter those changes. However, it is a principle of legal policy that a person should not be penalised except under clear law.<sup>2</sup> The Law Society is concerned that the provisions as drafted are too vague for criminal sanctions to apply.

The Law Society considers that the criminal offences of engaging in money laundering and non-reporting of suspicious transactions, including where the regulated person was not himself suspicious, but on objective facts should have been, are quite sufficient. The current provisions outlined above take the further step of criminalising the failure to have a suspicion. This is a step too far.

The Law Society considers that supervisory authorities will be better placed to encourage relevant persons and firms to have systems in place which are responsive to developing risk areas. Enforcement of this aspect of the regulations through this method, rather than by criminal sanctions, will result in a more co-operative approach to responding to developing money laundering and counter terrorist risks.

***The Law Society recommends that criminal sanctions should not attach to the failure to comply with regulations 11(5) and 14(1)(b).***

### 13 Implementation date

The implementation date for the directive is 15 December 2007. The Law Society understands that the government is committed to having the regulations in place by that date, and to that end it is likely that the regulations will be laid before Parliament in July 2007. At best this will leave only five months for firms to become compliant with the new regulations. Under the 2003 regulations, relevant persons had three months to adapt to the regulations. However, there are a number of significant differences from the 2003 regulations to the draft regulations such as:

- New categories for simplified CDD
- New categories for enhanced CDD
- New procedures required for identifying PEPs
- New requirements for identifying beneficial owners
- New requirements for identifying existing customers

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<sup>2</sup> see e.g. Bennion, *Statutory Interpretation* (4<sup>th</sup> ed.) at section 271

- An ability to continue with a business relationship without conducting CDD in certain circumstances
- Reliance on third parties and outsourcing for CDD requirements
- New requirements for the timing of CDD

These differences will require a significant re-drafting of professional guidance, which given the many amendments sought by the Law Society, not to mention those likely to be sought by other consultees, cannot be completed - or in some cases started, in view of the fundamental nature and difficulties of the issues - until it is clear whether amendments will be made.

If and when guidance is provided, solicitors will have to amend a number of their policies, procedures and systems to cater for the changes to the law, they will also have to re-train all of their lawyers and other relevant staff.

For large firms this is likely to involve developing in house-programs and then training hundreds of staff members. Firms which work on cross-border transactions will also have to consider the impact of these regulations and regulations in other EU countries on such transactions. For smaller firms this will involve competing for the time of a handful of anti-money laundering trainers who have experience in how such regulations apply to the legal sector, which is significantly different from any of the other regulated sectors.

It is the Law Society's view that it will take at least nine months from the time that the draft regulations are laid for the legal sector to become compliant. This would make a more realistic implementation date the start of the 2008 – 2009 financial year.

Such a delay is entirely in keeping with the implementation of the second money laundering directive. Although it was required to be implemented by member states by 15 June 2003, the UK implementing regulations did not come into force until 1 March 2004 generally, with some parts not coming into force until 14 January 2005. Other European countries took even longer to implement the directive. While the Law Society appreciates the government's desire to comply with the implementation date set by the European Commission, the Law Society is concerned that the directive be implemented in a clear, proportionate and workable manner, with firms being given a reasonable time to fully understand what is required, rather than to see extensive inadvertent non-compliance by an under-prepared regulated sector due to over-speedy implementation.

***The Law Society recommends that the draft regulations come into force on 1 April 2008.***

## **Part 2 - Response to questions asked in the consultation**

### **1. The government would welcome your comments on the list of activities included and excluded in the definition of accountant or tax advisor.**

Including law firms offering full business services within the definition of accountant or tax advisor is confusing and unnecessary.

Where an independent legal advisor is providing taxation advice, they are providing the services of a tax advisor by way of a business and are clearly covered. Any other 'business services' which a lawyer may provide are, in the Law Society's view, adequately covered by the activities specifically outlined under the description of regulated persons. An overlap between the definitions would reduce clarity.

### **2. What activities do you think fall within the terms mentioned in para 2.14? When listing these, if you do not think an activity should be included please include your reasons.**

The Law Society considers that the definition of financial institution in the draft regulations is unnecessarily confusing.

By defining investment firms by reference to the MiFID and excluding authorised persons, it appears that not all persons and/or firms regulated under the Financial Services Market Act 2000 will actually be covered by the money laundering regulations.

Firstly, it is not clear why some FSA regulated firms should be covered and others not. Secondly, while individuals in investment firms are well aware of whether they are regulated by the FSA or not, they may not be aware if they are covered by the newly introduced MiFID.

With respect to money brokering and safe custody services, the Law Society is of the view that it is sufficient to restrict the application of the regulations to the FSA regulated firms providing this service, whether it is provided by that firm or through an attached nominee company.

### **3. Do you agree with the proposed threshold for total turnover criterion for financial activity on occasional and limited basis derogation?**

As stated in the Law Society's previous response on this issue<sup>3</sup>, the need to satisfy all of the criteria set out in schedule 2(1) in order to qualify for the exemption means that the exemption is so restrictive that it is difficult to see how it could be of assistance.

### **4. The government would welcome your comments on this proposal to refine the definition of a business relationship.**

The Law Society is pleased to see that the Treasury adopted the recommendation that the formation of a business relationship must be the intention of the relevant person, rather than the client.

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<sup>3</sup> <http://www.lawsociety.org.uk/influencinglaw/policyinresponse/view=article.law?DOCUMENTID=266118>

- 5. Are there any other products that you believe meet the conditions of the derogation to the implementing measures outlined in paragraph 2.38 above?**

No comment

- 6. Do you agree that HMRC, OFT and Local Authority Trading Standards Service, and the FSA should have these powers?**

See point 11 in Part 1 of this response.

- 7. Do you agree with the list of activities that are and are not caught within the definition of a trust and company service provider?**

No comment

- 8. Fit and proper test**

No comment