



The Law Society

## **Combating Money Laundering and Recovering Looted Gains**

Response to the draft report by Transparency International (UK)

May 2008

supporting  
solicitors

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# 1. Introduction

The Law Society (TLS) is the professional body representing over 115,000 solicitors practising in England and Wales. We have been actively lobbying on behalf of the profession with respect to anti-money laundering (AML) obligations 1993. Our key aim is to ensure that the anti-money laundering obligations imposed on solicitors and others in the regulated sector are clear, proportionate, workable and effective.

TLS made a number of representations to the EU during the drafting of the third European directive on money laundering (the third directive) particularly with respect to the issue of enhanced due diligence for politically exposed persons (PEPs). Many of our recommendations, which were accepted, were aimed at:

- creating greater proportionality in the PEPs obligations,
- increasing certainty and workability for the regulated sector,
- protecting fundamental human rights of those PEPs seeking to undertake legitimate activities, while
- ensuring that greater safeguards were put in place to limit the ability of corrupt PEPs to launder funds through the regulated sector.

We also encouraged governments to provide a list of their own PEPs to the regulated sector for free, as the government which appoints a PEP is better placed than private individuals to know who that PEP is, and who their close family and business associates are. To date no government has been willing, or perhaps able, to provide such a list to assist the regulated sector to meet its obligations with respect to PEPs. Despite this lack of assistance, failure to meet these specific obligations may still result in criminal sanction.

TLS was encouraged that TI (UK) were undertaking this project with a specific focus on PEPs. We had hoped it would result in greater clarity as to how corrupt PEPs are seeking to exploit all aspects of the regulated sector within the UK and would encourage governments to better understand their own PEPs and share that information with the regulated sector.

Instead, this report seeks to actively roll back many of the successes won by the Law Society during the drafting of the third directive and proposes a disproportionate, zero failure, and costly anti-money laundering regime in the UK. These proposals go beyond the issue of PEPs and extend to the identification of beneficial owners. They are made in the face of clear guidance from Financial Action Task Force (FATF), the leading international organisation on AML, that anti-money laundering obligations are to be applied on a risk-based approach.

We are very concerned that these wide ranging recommendations are made, it seems, with no regard to the costs imposed on the private sector, despite the current difficult economic climate, and without clear evidence to justify the need for the changes. The report appears to mistakenly focus on a small number of large financial institutions and does not appear to appreciate that AML obligations apply across an extensive regulated sector, the majority of which is comprised of small to medium businesses.

We also note with considerable concern that the few examples of corrupt PEPs pointed to in the report to justify the recommendations, include activities undertaken prior to the implementation of the second European money laundering directive (the second directive). The specific requirements to conduct enhanced due diligence on PEPs were only introduced through the third directive, which was incorporated into UK law on 15 December 2007. Consequently we are of the strong view that such examples provide little real assistance in assessing the current robustness of the AML regime in the UK.

We do not believe that the examples significantly increase the knowledge of the regulated sector in how corrupt PEPs are targeting the UK. They merely highlight the stereotypical PEP methodology, namely a high profile primary PEP using vast amounts of government money, which could not belong to them, on private expenditure. While it is important that the regulated sector remain alert to the obvious, very few of the estimated 150,000 regulated entities in the UK will ever come across this methodology. As a result it is not proportionate for small businesses to spend thousands of pounds introducing sophisticated systems to detect something which will never occur within their business.

In our view, the use of such obvious methodologies will only serve to promote disengagement with the regime by the regulated sector on the basis that it is simply another level of bureaucracy which has no application to the normal course of business. A better approach would be to provide examples of less obvious ways in which the regulated sector could be used.

We feel that TI (UK) could have taken this opportunity to consider how more obscure or secondary corrupt PEPs are utilising the UK regulated sector and to add to currently limited knowledge of the real risks posed by PEPs so that the regulated sector could better apply risk assessments. This also would have been an opportunity for TI (UK) to address the emerging PEP phenomenon resulting from increased nationalisation in the financial and manufacturing sectors across the globe.

While TLS cannot support the recommendations of this report in their current form, we understand that DIFID and SOCA are undertaking a project aimed at gaining a better understanding of PEPs in the UK and how corrupt PEPs are seeking to exploit our regulated sector. TLS will continue to provide as much assistance as it can to that project and is hopeful that it will deliver real and positive change to the regulated sector. TLS hopes that through this enhanced knowledge the effectiveness of the regulated sector will be increased in combating the risks posed by corrupt PEPs.

TLS has commented on a number of specific recommendations below to better illustrate why we do not agree with the analysis set out in the report. We hope this will promote greater understanding of the experience of those within the regulated sector and to highlight concerns of possible unwarranted infringements of fundamental human rights.

As we have noted above, a number of the recommendations contained in the report are directed at financial institutions alone, but the report is silent as to whether this is an intentional restriction and if so, why such a restriction is appropriate. As the practice of FATF, the EU and the UK is to extend AML requirements to the regulated sector as a whole, unless there is a specific reason to exempt certain parts, TLS has responded to all recommendations as if they are intended to extend to the regulated sector as a whole.

## **2. Recommendations and observations in relation to PEPs**

### **2.1. UK compliance**

FATF recommendation 6 provides:

Financial institutions should, in relation to politically exposed person, in addition to performing normal due diligence measures:

- a) Have appropriate risk management systems to determine whether the customer is a politically exposed person.
- b) Obtain senior management approval for establishing business relationships with such customers.

- c) Take reasonable measures to establish the source of wealth and source of funds.
- d) Conduct enhanced ongoing monitoring of the business relationship.

The report notes at page 18, that in the July 2007 mutual evaluation of the UK, FATF raised a concern that these obligations were not legally enforceable. At page 37 of the report, it suggests this was because the government was relying on the JMLSG guidance instead of enacting law.

The evaluation was actually conducted during 2006. The third directive, which incorporated recommendation 6, had only been passed in late 2005 and was not required to be transposed into national law until December 2007. For the purpose of clarity and stability, there was little purpose in the UK government enacting legislation to comply with FATF recommendations before the EU had done so, as they may have been required to change that law in light of the EU directive. The JMLSG guidance was simply highlighting best practice within the industry in light of international recommendations which were likely to be incorporated into law in the near future. The FATF mutual evaluation report also noted that the UK was addressing this issue through its Money Laundering Regulations 2007 (2007 MLR). The UK transposed recommendation 6 through regulation 14 and 20 of the 2007 MLR on 15 December 2007.

## **2.2. Systems**

The report makes a recommendation at page 10 and discusses further at paragraph 94, that the 2007 MLR and the JMLSG guidance should make it unambiguous that a financial institution should always have systems in place to detect and identify PEPs.

Regulation 20 relevantly provides:

- (1) a relevant person must establish and maintain appropriate and risk-sensitive policies and procedures relating to (a) customer due diligence measures ...
- (2) The policies and procedures referred to in paragraph (1) include policies and procedures .... (c) to determine whether a customer is a politically exposed person.

TLS disagrees that FATF has an absolute requirement that all PEPs must be identified; as if that is the case the reference to risk systems is redundant. In TLS's view the regulations unambiguously require that every regulated entity should have in place a system for identifying a PEP. The sophistication of that system and applicability across the client base will depend on the actual risks of the regulated entity acting for a PEP. FATF promote the risk based approach, which is not a zero failure approach. This does mean that, on occasion, a regulated entity may act for a PEP without realising that this is the case and, therefore without having undertaken enhanced due diligence. An effective system will ensure that where such cases are later identified, lessons can be learnt by the regulated entity, and possibly the sector as a whole, and both systems and risk assessments enhanced.

The greatest challenge for the regulated sector is not the lack of systems, but rather the lack of information from government to help understand the real and current risk posed by PEPs which the systems need to mitigate.

## **2.3. Identify beneficiary before payment**

The report recommends at page 10 that the 2007 MLR should require beneficiaries to be identified and their identity verified, at least before payment is made. If this cannot be established, the report recommends that the payment should not be made and the account closed.

TLS is particularly concerned about this recommendation as it:

- does not specifically relate to PEPs,
- does not identify the risk it is seeking to address,
- goes significantly further than the FATF recommendations,
- removes the risk based approach,
- incorrectly refers to beneficiaries when the regulations refer to beneficial ownership,
- is insufficiently focussed as it does not require that the beneficiary needing to be identified is the beneficiary being paid,
- significantly infringes on the fundamental human rights of PEPs, through their access to the financial system, without the requirement for a suspicion of money laundering
- fails to recognise the difficulty of verifying some beneficial ownership information, and
- fails to provide any suggestion as to what should happen to the funds remaining in the account when it is closed or what avenues of redress the client would have to regain those funds.

## **2.4. PEP lists**

The report recommends at page 10 that the FSA and other enforcing bodies should ensure that each financial institution maintains an up to date list of PEPs. This is discussed further at paragraph 95 of the report.

This recommendation fails to specify whether the list is to be a list of all PEPs or just the PEPs which the financial institution has as clients. The former is practically impossible for those in the private sector to achieve. The latter is not specifically required by either the FATF recommendations or the 2007 MLR. While for large financial institutions and other regulated entities with a centralised and computerised database, the creation of a list of current client PEPs should be achievable, this is not necessarily the case for smaller firms elsewhere in the regulated sector.

While TLS agrees that systems should be in place for small firms to assess whether an individual client is a PEP, the maintenance of a list of PEPs may have a compliance cost implication. In the absence of information outlining the current scope of corrupt PEP risks to the regulated sector, including the smaller end of the regulated sector, TLS is concerned at the proposed imposition of further regulatory costs above and beyond the legislative requirements.

## **2.5. Domestic limitations of PEPs**

The report recommends at page 10 that the JMLSG guidance should be amended to require financial institutions to ask PEPs about any limitation on their ability to hold assets outside their home country, to obtain copies of any asset declaration and to have regard to the legal obligations on foreign PEPs when deciding whether or not to accept the account and when establishing their monitoring procedures. This is further discussed at paragraph 95 of the report.

TLS is concerned that this recommendation is increasing compliance burdens and possible restrictions on a PEPs fundamental human rights without reference to actual UK legislative requirements, appropriate judicial overview, or why the costs of such extra compliance are warranted.

If this recommendation is focussing on international sanctions, these are already provided for in UK law. These requirements are above and beyond normal anti-money laundering obligations and have quite significant penalties for non-compliance. The recent ECJ case of Kadi has also ensured that the fundamental human rights of those covered by such sanctions lists within the EU are protected appropriately.

If this recommendation is referring to other restrictions only, such as those outlined in paragraph 95.7 of the report, it would be useful if such restrictions were comprehensively rather than illustratively referenced and if the scope of the problem were assessed. If this is a significant issue, simply asking a client if they are restricted from starting a business relationship in the UK is not very robust, in our view, given that the client if so restricted is actually attempting to breach the restriction.

TLS is not aware of any UK legislative requirement, or FATF recommendation, which obliges the regulated sector to research such foreign restrictions when forming a business relationship in the UK. Practical difficulties with such an approach include such restrictions not being publicly available or well publicised, the information about the restrictions not being available in English, and the potential cost and delay in obtaining this information independently. If a government database is to be established, it should be available free of charge to the regulated sector.

From a jurisprudential perspective, there are concerns about the potential lack of legislative and judicial safeguards existing in certain countries which may impose such restrictions. There may be very good reasons why the UK government has chosen not to recognise such restrictions and it could be an unjustified breach of fundamental human rights for regulated entities to unilaterally elect to enforce those foreign restrictions. This could leave regulated entities open to expensive legal proceedings for discrimination or breach of contract.

## **2.6. MLR 14**

The report recommends at page 10 that MLR 14 should require PEP identification as part of risk management and it should be normal practice to have specified measures defined in an institution's AML policy for establishing whether or not any customer is a PEP.

TLS believes that regulation 20 of the 2007 MLR covers this aspect. The point about a risk based approach is that not every client will go through full PEP screening if the risk profile of the firm or the client type is not such as to raise the concern that they are a PEP. Within the legal sector, fee earners and accounts staff are reminded to remain alert to circumstances within a retainer which may suggest a client is an unidentified PEP, such as correspondence on government institution letterhead or monies being received from government accounts. This is a proportionate and risk attuned response for many smaller firms who would not normally act for PEPs.

## **2.7. PEP exclusion lists**

At paragraph 89 the report suggests that guidance needs to be made clear that if an account is not opened because of concerns a PEP will use it for money laundering, then this should be a suspicion of money laundering and a SAR should be made.

At paragraph 90, the report goes on to suggest that if there was a decision not to open the PEPs account, this should be recorded by SOCA and shared with others in the regulated sector, both in the UK and overseas.

The Proceeds of Crime Act 2002 already makes it a criminal offence not to report a suspicion of money laundering which came to you in the course of your employment, if you are in the regulated sector, whether or not it is about a client. As such it can apply to a person who you chose not to do business with.

The test of suspicion is very low, it must simply be something which is more than merely fanciful. There is a real risk that a PEP will have entirely legitimate activities that they are undertaking, but because of the risk appetite of the regulated entity, or the jurisdiction that the PEP comes from or general unproven allegations against them, the regulated entity will



simply choose not to take the risk of transacting with them. To then place these persons on a SOCA exclusion list, without evidence of wrong doing, and preclude their access to the financial system and legal system would be an unacceptable infringement of their fundamental human rights. The report fails to contemplate how such PEPs would be able to access natural justice and remove themselves from this black list.

In relation to the observations at paragraph 91 about possible uneven regulation across the regulated sector, HM Treasury and the regulated sector have already identified this as a possible issue and are addressing this through the Supervisors' Forum.

## **2.8. Domestic PEPs**

The report at paragraph 92 recommends that the UK should encourage FATF to include domestic PEPs within the enhanced due diligence obligations.

The UK government does not require FATF's permission to include domestic PEPs if it thought there was a real money laundering risk. While TLS appreciates that domestic PEPs are not immune from money laundering risks, without clear evidence of endemic corruption in UK PEPs, we would not encourage the extension of criminal sanctions to our members for failure to follow specific processes on all occasions. We continue to highlight to our members that it is good practice to risk assess all clients and the enhanced due diligence measures outlined in regulation 14 can be useful to mitigate other areas of enhanced risk.

## **3. Recommendations and observations in relation to AML compliance**

### **3.1. Professionals – reporting levels and supervision**

The report at page 34, in paragraph 86.4 makes the following observation:

The number of reports from company formation agents in the 2008 Report remains very low (48 of the 210,500) and the reporting from accountants and lawyers (who would be likely to form part of the process of laundering the proceeds of corruption) remains unexpectedly low.

The 2008 SAR annual report covered the period October 2007 to September 2008. As TCSP's were only specifically covered by the AML regime in December 2007 and their regulator's main guidance to date has covered whether or not they need to register, it is perhaps not surprising that they feature in a small number of reports by comparison to the level of reporting as a whole.

The report fails to make clear the basis for stating that reports from lawyers are unexpectedly low or what conditions make the report writers assume reports should be higher. The SARs Review Committee has not raised any concern that solicitors or accountants are consistently involved in transactions where the circumstances are such that they should be suspicious and are failing to report.

UK solicitors made over 6,000 reports in 2008. This compares to lawyers in most other European jurisdictions who make less than 10 per year. The report also fails to take into account the more personalised nature of the interaction between solicitors (and accountants) and their clients, which may mean that client due diligence procedures are more effective in turning away clients that would later result in reportable suspicions.

With no evidence based assessment of the money laundering threat to the UK generally or through different sectors specifically, it is very difficult to make any credible assessment of



the level of suspicion which should exist in any sector within the UK. For this reason TLS is very concerned about the recommendation at paragraph 87.3 of the report which promotes a general increase in the number of reports for the mere sake of an increase in reports, rather than in response to evidence based risk.

At paragraphs 101 to 106, the report relies on the UK threat assessment to assert that there is a significant problem with lawyers and accountants being involved in money laundering activities and then goes on to question the effectiveness of these professional bodies in supervising their members for AML compliance.

The UK threat assessment does not itself provide evidence to support a claim that solicitors or accountants are actively involved in money laundering. Even with a new objective test of suspicion and failure to report offences introduced with POCA in 2002, TLS understand that less than 10 solicitors have been convicted of being involved with money laundering. Out of a population of 115,000 solicitors in England and Wales, we suggest that this is not evidence of a high risk professional group. We do believe that the more methodologies and trends in money laundering provided by law enforcement which are relevant to solicitors, the more solicitors will be able to protect themselves and be alert to warning signs.

With respect to the suitability of the professional bodies to supervise their members, both TLS and ICAEW have long records of effective self regulation and have been supervising their members specifically on AML compliance since the introduction of the first directive. TLS is considered internationally to be the lead professional body in the legal sector in the area of AML support and guidance for its membership.

### **3.2. TCSPs**

TLS notes the recommendation at paragraph 101.1 of the report which provides:

Because of the high vulnerability of companies and trusts to abuse by those who launder the proceeds of crime, TI (UK) remains concerned by the lack of effective regulation of TCSPs and recommends that the effectiveness of ML supervision by HMRC of TCSPs should be independently reviewed and reported no later than 2011.

TLS is concerned that the assertion of the vulnerability of TCSPs is not supported by any detailed statistical evidence within the report.

## **4. Recommendations and observations in relation to asset recovery**

### **4.1. Land ownership by PEPs**

The report at page 11 asserts that corrupt foreign PEPs often hold property in the UK through offshore vehicles. TLS would be interested in the statistics which support this assertion as well as information as to what proportion this is of all PEP land holdings in the UK and the proportion of all land transactions in the UK each year.

A recommendation is made at page 12 of the report that:

Trusts and similar organisations acquiring property in England and Wales should provide the names and addresses of the trustees for inclusion on the Land Registry. If a case is made for not including these details in the public part of a register, they should still be filed and be available to law enforcement agencies conducting criminal

investigations. The identity of ultimate beneficial owners should also be available to law enforcement agencies conducting criminal investigations.

TLS has a number of concerns with the premises behind this recommendation.

- A trust is not an organisation, it is a legal arrangement.
- There seems to be a lack of clarity as to where the real AML risk comes from with a trust, with focus being placed on the identity of the trustees for inclusion on the registry and then the beneficial owner. The settlor introduces the funds. If those funds are the proceeds of crime the trust is tainted, if they are not, the trust is clean at the outset.
- The 2007 MLR already require the estate agents, solicitors, financial institutions and any TCSPs involved in the transaction to record the identity of the trustees and ultimate beneficial owners. Regulation 37 allows law enforcement to require that information for the purpose of enforcing the regulations. Law enforcement conducting criminal investigations more generally are able to access this information through normal investigative tools and court orders.

## 4.2. Jurisdiction of UK courts

At page 14 and 15, the report makes recommendations about limiting the ability of PEPs to challenge the jurisdiction of the UK courts with respect to asset recovery.

TLS is concerned that many jurisdictions which are likely to give rise to asset recovery relating to PEPs have questionable records with respect to corruption, political interference with due process and upholding the rule of law. TLS would not like to encourage the restriction of the UK court's ability to ensure a fair trial and the application of the rule of law within our jurisdiction without clear and compelling evidence that this is necessary. We do not believe that the current report has provided this evidence.

The UK courts have demonstrated over hundreds of years the capacity to robustly deal with challenges to their jurisdiction and those who would seek to abuse their processes. There is no evidence that the UK courts are overwhelmed by celebrity or intimidated by power such that they are unable to apply to PEPs the same independent and objective judgement which they apply to others whose assets the Crown seeks to confiscate.

## 5. Other factual errors

Throughout the report, the Law Society has noticed a number of factual errors which are set out below. These are the errors we have thought relevant to draw to TI (UK)'s attention and should not be taken as an endorsement of the factual correctness of the remaining content of the report.

**Page 8:** The report asserts that JMLSG provides guidance to the financial sector and other professionals.

The JMLSG provides guidance for the financial sector. Guidance for professionals and others within the regulated sector is provided by the relevant supervisors or professional bodies.

**Page 9:** The report asserts that the 2007 MLR do not require reporting institutions to identify a beneficiary of trust as a matter of routine. The report suggests that this is contrary to the FATF recommendations. This is explored in further detail in paragraph 94.

Regulation 5 of the 2007 MLR requires that the regulated sector identify a beneficial owner where one exists. The risk based approach applies to verification of the identity, although in

practice, in many cases the information used to identify someone will also be sufficient to verify their identity. Under the regulations the definition of beneficial owner extends to persons entitled to property at some point under a trust. There is a very detailed list of which such persons qualify as a beneficial owner and how they are to be identified in regulation 6.

It is important to note that as a matter of law a beneficiary under a common law trust is not a beneficial owner, as they do not have ownership rights. The inclusion of beneficiaries of common law trusts as beneficial owners under the 2007 MLR is an artificial construct and misnomer to cater for the divergence between the civil and common law concepts of ownership.

In considering whether this is in accordance with the FATF recommendations, FATF recommendation 5 provides in part:

CDD measures to be taken are as follows:

...

b) identifying the beneficial owner, and taking reasonable measures to verify the identity of the beneficial owner such that the financial institution is satisfied that it knows who the beneficial owner is. For legal persons and arrangements this should include financial institutions taking reasonable measures to understand the ownership and control structure of the customer.

FATF recommendation 34 provides

Countries should take measures to prevent the unlawful use of legal arrangements by money launderers. In particular, countries should ensure that there is adequate, accurate and timely information on express trusts, including information on the settler, trustees and beneficiaries, that can be obtained or accessed in a timely fashion by competent authorities. Countries should consider measures to facilitate access to beneficial ownership and control information to financial institutions undertaking the requirements set out in recommendation 5.

The interpretive notes for the FATF recommendations outline that the types of measures that would be normally needed to satisfactorily perform the function of identifying the beneficial owners include:

Identifying the natural persons with a controlling interest and identifying the natural persons who compose the mind and management of the legal person or arrangement.

In TLS's view, the EU directive and the 2007 MLR go further than required by FATF in relation to trusts, as under common law a beneficiary does not have control over the trust and does not constitute the mind or management of the arrangement. If the beneficiary of a common law trust is not also the trustee or the settlor, then they have no ability to taint the trust either through the introduction of tainted funds or the investment of funds in a manner which produces criminal property. TLS is concerned that the focus on beneficiaries of common law trusts in anti-money laundering compliance indicates a lack of understanding as to how common law trusts operate in practice and the real risks they pose with respect to money laundering.

TLS is concerned that the discussion in the report at paragraph 94 demonstrates a significant lack of understanding as to the law relating to common law trusts and a failure to appreciate the detail in regulation 6 (3) and (4) of the 2007 MLR. Many assertions are made as to how trusts are used to launder funds but no evidence is provided of such use, nor is statistical evidence advanced to establish the scope of the problem. TLS supports greater accessibility of beneficial ownership to the regulated sector to assist with compliance. However we recognise that this is an infringement of the fundamental human right to privacy

of many people who are conducting legitimate business and would prefer that such an extension is done on the basis of actual evidence rather than anecdotal evidence.

**At page 28, paragraph 52:** The report states that it is the JMLSG which differentiates between standard, simplified and enhanced due diligence measures. In fact it is the 2007 MLR which differentiates between the various measures.

The report also states at paragraph 52 that the long definition of beneficial owner is as a result of the wide range of entities and arrangements. It is in fact because the civil concept of beneficial ownership does not have an equivalent legal translation in common law. Consequently for the legislation to be constitutionally valid, full definitions in terms which have meaning in the UK were required.

The report further states at paragraph 52 that there is a requirement that a profile of expected account activity is required at the commencement of a business relationship and the reporting of a suspicious activity. The 2007 MLR simply requires that you understand the purpose and intended nature of the business relationship and that you review transactions throughout the course of the relationship to ensure that they are consistent with the knowledge and risk profile of the customer. There is no requirement for a specific document outlining expected account activity to be prepared, either at the commencement of the business relationship or when making a SAR. This error is repeated in paragraph 93.2 of the report with respect to the FATF recommendations.