



The Law Society

Development of a 4th Money Laundering Directive

Response to the European Commission's review of the third
money laundering directive

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1. Introduction

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

The Law Society welcomes the opportunity to respond to the European Commission's consultation on the development of a fourth European Money Laundering Directive (fourth directive).

1.1. Preparation of this response

This response has been informed by numerous consultations and our work on anti-money laundering with the legal profession in England and Wales over the past decade. It has been prepared with assistance from members of the Law Society's Money Laundering Taskforce.

1.2. Terminology and format

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

We have generally followed the format of the consultation in providing our comments, although we have addressed the specific questions on the legal profession at an earlier juncture, due to their importance to our membership.

2. Application of the Directive

2.1. The risk-based approach

The Law Society supports the application of the risk-based approach to AML/CTF obligations. We welcome the embedding of the risk-based approach in the Financial Action Taskforce (FATF) standards and encourage the Commission to do the same in the development of a fourth directive in this area. We do not believe that the development of a European regulation on money laundering would adequately support a risk-based approach by Member States or regulated entities.

2.1.1.Risk assessments by Member States

The Law Society supports a minimum standard for Member States in undertaking risk assessments. We understand that FATF is developing guidance on this issue and support the Commission working with FATF to develop a consistent approach to risk assessment.

While the European Union is a single internal market, in reality Member States face different money laundering risks. The Law Society is concerned that the creation of a publicly available supranational risk assessment would be unlikely to provide more detail than the FATF global threat assessment, nor would it be likely to specify which threats/risks apply within individual Member States.

The resources required to generate a European risk assessment are likely to outweigh the benefits, particularly as regulated entities will focus on their national risks. Access to national risk assessments by such entities operating in more than one member state would help those entities identify and manage their own risk; while a supranational risk assessment may lead to countries outside Europe drawing inaccurate conclusions as to the risks within specific Member States or posed by types of regulated entities within Europe.

2.1.2.Risk assessment and supervision

The Law Society welcomes the clarity provided by the interpretive notes to FATF Recommendations 26 and 28, on the application of the risk-based approach to supervisors and self-regulatory bodies (SRBs). We believe that the fourth directive should recognise these requirements.

FATF has produced guidance for the relevant sectors on the risk-based approach. The new interpretive notes require supervisors and/or SRBs to create guidance on the risk-based approach tailored to the relevant jurisdiction and sector in which they operate. The Law Society notes the suggestion that the AMLC could provide guidance. However we do not believe a third layer of guidance from the European Commission would enhance clarity, be the best use of limited resources or add real value to assist regulated entities to prevent the use of their services by money launderers and terrorist financiers.

2.1.3.Risk assessment by regulated entities

We see this proposal as a clarification of existing requirements, rather than the imposition of a new requirement, given that the third directive requires a regulated entity to demonstrate to a supervisor that their AML/CTF systems are consistent with the risks they face. We believe that without such procedures it would be difficult for a regulated entity to meet this obligation.

We welcome the suggestion that risk-based procedures should be appropriate to the size and nature of the entity as this enables the entity to assess the risks they face and tailor their procedures to manage those risks. Keeping those procedures documented and up to date, whilst challenging for smaller firms, enables those entities to manage their risks and demonstrate to the supervisor that they are

meeting their obligations. Any further detail, beyond those contained in the third directive, as to the content of procedures should be left to Member States, in consultation with supervisors and SRBs, to ensure the requirements are sufficiently tailored to the relevant risks.

Impact Assessment

We believe that most of our medium and larger firms will already have a risk assessment and risk-based procedures in existence and should only need to update these in light of changes to the third directive.

It is difficult to estimate the level of cost but it will be necessary to review existing procedures/policies/risk assessment and update them, provide training to relevant staff, which will include those in the regulated sector as well as the specialist compliance staff and ensure that any system changes are implemented. If it took an MLRO, on a salary of £60,000 pa, one week to review the revised requirements and implement them, without taking into account the training costs/lost fee earning time, the cost incurred would be about £1,200 per firm.

For smaller firms, the task is likely to be more onerous as their existing risk-based procedures may be less sophisticated and may need more work to ensure they are sufficiently robust. As a supervisor, the Law Society is committing to assisting firms to meet their obligations and is in the process of developing an AML/CTF toolkit to complement our AML/CTF practice note. Such toolkits issued by the Law Society in other areas generally retail for £60 and should be able to be tailored to the firm within a day. Using the same approach as above, the cost incurred would be £240 plus £60 i.e. £300. There are about 8,500 firms of between 1 to 4 partners giving a total cost of about £2.5m for that sector.

2.2. Inclusion of tax offences as predicate offences

The Law Society is of the view that the current definition of all serious crimes in the third directive would be sufficient to capture tax crimes where intentional dishonesty is an element of the offence.

We do not believe the definition of tax crimes should be expanded to include situations where the penalty is an administrative fine, where the offence is based merely on late filing, mistake or other oversight. Care should be taken to ensure that legitimate tax planning and minimisation are not included within the remit of the definition.

The Law Society has previously expressed concerns that the manner in which tax crimes have been included in the UK has effectively resulted in all of an individual's property being tainted for ever, once they are suspected of engaging in tax evasion. We do not believe that the use of the secondary money laundering offences in this way is an effective or proportionate approach to increasing compliance with the primary tax obligations. We would welcome the opportunity to discuss these issues with the Commission, particularly how to avoid these specific pitfalls when incorporating tax offences as predicate offences within a fourth directive.

More detailed comments on our concerns were shared with FATF at pages 19 to 23 of our January 2011 response:

<http://www.lawsociety.org.uk/new/documents/aml/fatfconsultation.pdf>

3. Role of lawyers

The Law Society welcomes the opportunity to comment on the Commission's observations with regard to the role of lawyers under the third directive.

Impact assessment

The Commission has asked for an estimate of how many lawyers are actually covered by the third directive. The definition of independent legal professional focuses on firms and sole practitioners. As at 31 July 2011, there were 10,202 solicitors' firms (including sole practitioners) in England and Wales. While there are some firms who will solely undertake criminal defence, litigation or other non-regulated work, we believe most firms will undertake some work which is covered by the third directive.

For this reason we suggest that the Commission use the figure of 10,000 law firms in England and Wales when conducting the impact assessment for the fourth directive. This figure does not take into account the number of firms in Scotland and Northern Ireland, regulated by the Law Societies of Scotland and Northern Ireland respectively or other firms in the legal sector in the UK, e.g. barristers or licensed conveyancers.

3.1. Reporting exemption

The Law Society is satisfied that the third directive itself and its implementation in the UK adequately protect legal professional privilege, both for litigation and for legal advice, and strikes a balance between conflicting fundamental human rights.

However, we note that the European Court of Justice, in response to previous legal challenges, questioned the permissive nature of the exemption. We also understand from European colleagues that some Member States have previously not elected to protect legal professional privilege or secrecy in a manner entirely consistent with the full constitutional requirements within their jurisdiction.

For the avoidance of further doubt, we support the recasting of the current exemption in Article 23(2) in line with the FATF standards, so that it simply provides:

Member States must not apply the obligation laid down in Article 22(1) to notaries, independent legal professionals, auditors, external accountants and tax advisors where the information was obtained in circumstances where they are subject to professional secrecy or legal professional privilege.

3.2. Level of reporting

We believe there may be a number of legitimate reasons for the different level of reports made by designated non-financial businesses as compared to financial institutions. These include the different type of relationship which such entities usually have with their clients and the different levels of transactions undertaken on a daily basis. Further, we do not believe it is possible or appropriate to state that a given level of reporting for any sector is sufficient or not sufficient, when reporting is based on a subjective judgement. However, we appreciate that questions may be raised where any sector repeatedly makes nil reports year upon year.

It is worth bearing in mind that in many Member States, notaries take the steps to effect the transaction in a manner similar to activities undertaken by solicitors in the UK; while continental lawyers or advocates will often provide legal advice and engage in advocacy work, similar to barristers in the UK. The diverse reporting levels across the legal sector in different Member States may reflect this spread of roles and activities.

We agree that effective targeted guidance from supervisors or SRBs and increased feedback from financial intelligence units (FIUs) may assist in addressing a complete absence of reports and improving the quality of reports made. If complete absence of reporting continues where such guidance and feedback exists, the Commission may seek specific information from Member States of instances where reports should legally have been made and what sanctions were applied for the failure to make those reports.

3.3. Reports to self-regulating bodies

The Law Society has not sought the option under Article 23(1) to receive direct reports from our members, but we understand that some legal sector SRBs have been given this role. We agree that SRBs should not filter reports to the FIU by substituting their own judgements as to what amounts to a suspicious or unusual transaction.

However, where a SRB receives a report that a regulated entity is not legally required to make (because of the reporting exemption) nor legally permitted to make (because of the requirement to protect the client's fundamental human rights, breach of is sanctioned by way of a criminal penalty which in some Member States) it cannot be appropriate for the SRB to be complicit in that breach by forwarding the report to the FIU. We do not see this approach as contravening the non-filtering provisions in Article 23.

4. Client Due Diligence

Impact assessment

The Commission has asked for information on the costs incurred in complying with the third directive, as distinct from due diligence undertaken for other legislative, regulatory or business reasons.

There is no separate legal or regulatory requirement on our members to independently verify the identity of their clients or the beneficial owners. While members will conduct checks to assess whether they can act for 2 or more clients, those will generally be undertaken against internal client databases using basic information provided by the client.

The checks undertaken for AML/CTF purposes will be adapted in some cases by firms to assist in assessing the credit worthiness of a client and reputational issues associated with the client. However, absent the requirements set out in the directive, it is unlikely that firms would have adopted the specific processes required by the third directive to test credit worthiness or reputation, or that so many clients would be subject to such checks.

The main overlap with other AML/CTF checks would relate to compliance with the sanctions regime and possibly for ensuring that the firm was not being used to perpetrate a fraud.

Most of our members do not separately record the costs of compliance which makes the provision of estimates for an impact assessment challenging. We have undertaken some surveys of our members on this issue, but the results are indicative rather than statistically robust. In our 2009 survey of top 100 law firms, easily identifiable costs associated with AML/CTF compliance ranged from £26,800 to £1,035,000 per year. These amounts are not insignificant when compared with the lower revenue of law firms as compared to multinational financial institutions.

Full details of our previous surveys with indicative costs are available at pages 24 to 27 and in Annex 3 of our 2009 response to HM Treasury which can be located here:

<http://www.lawsociety.org.uk/new/documents/aml/treasuryreviewsdec09.pdf>

4.1. Standard due diligence

The Commission has asked a number of questions around the provisions for standard due diligence (CDD).

4.1.1. Threshold for occasional transactions

In recent FATF and World Bank typologies, attention has been drawn to the non-application of CDD measures by trust and company service providers. In a number of instances it appears this may be due to the application of the occasional transaction threshold.

The provisions permitting the application of the threshold should be clear that it is the value of the transaction to the client, rather than the fees charged by the regulated entity which applies.

We appreciate this change may still not cover the creation of shelf companies, where there are no initial assets and the shares are allocated for nominal consideration. The Law Society believes that the creation of legal entities and arrangements is the key intervention point for limiting the misuse of trusts and companies for money laundering. The Commission could elect to address this loophole either through restricting the use of the threshold for occasional transactions involving trust and company creation or in the transparency requirements for beneficial ownership as discussed below at point 5.

4.1.2. Harmonisation of requirements

The Law Society believes that further harmonisation of the approach to identification and/or compiling a list of recognised documents created by Member States would undermine the application of the risk-based approach.

While recognised government issued identity documents form the basis of CDD checks for many regulated entities, the holding of such documents is not compulsory in all jurisdictions. Greater insistence on their usage could result in increased financial exclusion, a risk recently highlighted in the April 2012 World Bank report.

Further, as recent law enforcement operations in the UK have highlighted, the sale of fake 'identity packs' by organised criminals is a growing area of criminal enterprise, and one which will often not be detected by application of a purely paper-based CDD approach. We appreciate that many regulated entities will use a mixture of paper-based, internet and electronic verification measures depending on the size of their client base and the risks associated with that client base. The decision to use electronic verification measures is often unlikely to be made on a case by case basis, but will be made after considering the overall risks and resource implications for a firm.

The Law Society believes that regulated entities should continue to be allowed to use a wide range of independent data and information to verify identity in standard due diligence situations.

4.1.3. Reliance

The Commission has asked whether they should take steps to clarify the obligations on both parties when using the reliance provisions. The Law Society has frequently suggested that the reliance provisions would be more useful if the person who had relied were not penalised for failures in CDD where they had acted reasonably.

We understand from meetings with FATF, that the standard on this issue was not amended as Member States were of the view that if a regulated entity is not

prepared to stand behind the decision to rely, then they should not be using the reliance provisions. However, Member States indicated that it would be appropriate for relying entities to obtain indemnities from the entity they relied upon to guard against fines or loss incurred.

The Law Society agrees that the relying entity should be required to conduct their own risk assessment of the client, their own ongoing monitoring of the business relationship and their own assessment of the appropriateness of relying on the other entity. If they fail to take adequate measures in conducting these assessments, they are likely to be in breach of their obligations.

Reliance relates simply to the verification of identity and means that clients are not inconvenienced by having to produce documents to verify their identity multiple times in a single transaction. In circumstances where verification documents held by the entity relied upon are lost, destroyed or forged (either with or without connivance by an individual within the entity relied upon), it is unreasonable to hold the relying entity who acted in good faith, accountable for the non-availability of the CDD material when requested by supervisors or law enforcement. Further, indemnities are of no comfort when breaches of the CDD obligations are enforced by criminal sanctions.

We appreciate that the Commission's scope for amending the requirements, in light of FATF's decision not to do so, are limited. However the reliance provisions will continue to fail to deliver their full intended savings as long as criminal sanctions can be applied to breaches of administrative requirements and regulated entities continue to be at risk of penalties for matters outside of their control.

In a 2008 survey conducted of our membership, we found that less than 60% of respondents were willing to use reliance provisions in eligible cases and this percentage diminished when they were asked to rely on regulated entities other than solicitors. Only 48% of respondents were willing to allow anyone else to rely on them.

4.2. Enhanced due diligence

4.2.1. General EDD

Factors which may indicate an enhanced risk of money laundering in some situations will also often feature in many legitimate transactions, making blanket enhanced due diligence (EDD) requirements inefficient and disproportionate. Further, some factors will increase the risk of anonymity or identity fraud, while other factors will simply relate to the actual funds being used. EDD provisions will be most effective where the extra due diligence or enhanced monitoring measures are focused on the actual area of increased risk.

The Law Society supports a more general approach to EDD requirements, rather than providing specific lists of risk factors and mandated mitigation activities.

We particularly support a more flexible approach to EDD for non face-to-face clients and transactions.

4.2.2. Politically Exposed Persons

The Law Society believes that the current implementing measures for politically exposed persons (PEPs) are sufficient to cover those individuals appointed within international organisations.

We believe that the range of appointments which apply to domestic PEPs should be the same as those listed in the implementing measures for foreign PEPs. This can be achieved simply by providing that regulated entities must apply the steps outlined in Article 13(4) on a risk-based approach to politically exposed persons residing within a Member State.

We believe that the current limitation of mandated enhanced due diligence for PEPs to one year after they leave office is appropriate and proportionate, given the fact that very few PEPs are actually engaged in corrupt activities. Regulated entities should continue to assess the risks posed by clients who were previously PEPs in line with the general risk-based approach and apply the general EDD provisions where appropriate.

We do not support the further definition of senior management for the purpose of PEP EDD compliance. This is a risk-based decision which is best made by the firm in line with sector specific guidance issued by their supervisor or SRB.

We would welcome efforts by the Commission to encourage Member States to provide information to the regulated sector on the PEPs they have appointed. While it is appreciated that corrupt PEPs may still act through agents, government transparency in this area would make it more challenging for PEPs to launder the proceeds of crime and would help to reduce costs for regulated entities in detecting the more obvious high risk clients. Application of the general due diligence and ongoing monitoring obligations will still be effective in identifying situations where unrelated agents are being used by corrupt PEPs and the use of such an agent is more likely to raise concerns and prompt suspicious activity reports.

We welcome the World Bank's steps, through the Stolen Asset Recovery Initiative to publicise grand corruption cases and to raise awareness of, and access to, international asset and income disclosure requirements for PEPs. To promote consistency of approach and reduce duplication of effort, we would encourage the Commission to consider how it can promote involvement of Member States with the work already being undertaken by the World Bank.

Impact assessment

In our 2008 survey, 67% of respondents said that they did not have PEPs as clients. This will change significantly with the inclusion of domestic PEPs. During that survey 60% of those who had PEPs as clients said they used electronic verification as one method of identifying PEPs. With the extended

requirement to look for PEP beneficial owners and the inclusion of domestic PEPs, we anticipate a significant increase in our members turning to electronic verification to assist in meeting this obligation. Access to a basic PEP list through an electronic verification service where there is a small client base will still cost a few hundred pound per year. Access to a more sophisticated PEP system, higher numbers of checks and/or increased number of access licences for more staff members will be more likely to cost around £2,000 to £20,000 a year per electronic verification service used. In addition there will be associated staff costs as the requirements are expanded, due to the need for further training and more extensive client inception processes.

4.3. Simplified due diligence

FATF has provided significantly increased guidance on the approach which should be taken when allowing simplified due diligence, which will need to be reflected in the fourth directive.

The Law Society supports a statement of the general principles which would allow a Member State or regulated entity to decide if it was appropriate to apply simplified due diligence.

However, there were extensive discussions underpinning the creation of the indicative examples within the FATF interpretive note and we are not aware of any research over the past seven years which questions the factual basis for applying simplified due diligence to the existing range of clients and products in the third directive. Therefore, we would support the Commission listing these as examples of situations where simplified due diligence would be presumed to be applicable, unless the specific risk assessment of the Member State or the regulated entity provided otherwise.

The Law Society believes that at a minimum, in simplified due diligence situations a regulated entity should have knowledge of the identity of the client and undertake some ongoing monitoring. The simplification measures permitted should be focused on the area where the risk is lower, in terms of client identity, the transparency of beneficial ownership or the source of the funds.

4.4. Due diligence on pooled client accounts

Under the third directive, simplified due diligence is permitted by financial institutions in relation to pooled client accounts held by independent legal professionals. This was in line with FATF standards, which reduced the burdens around identification of beneficial owners. The Commission has said it is reconsidering this measure in light of the amendments to the FATF standards.

The Law Society believes that simplification measures around beneficial ownership for pooled client accounts held by independent legal professionals continue to be permitted by FATF standards.

In light of the strict regulation and scrutiny of such accounts, as well as the application of AML/CTF obligations to lawyers, we believe that it is appropriate for the Commission to conclude that the risks to financial institutions of organised criminals abusing pooled client accounts held by independent legal professionals are sufficiently mitigated to warrant such simplified measures. And finally, such simplification measures are the only way to enable financial institutions to proportionately continue to offer such accounts to the legal profession. Our detailed reasoning is set out below.

4.4.1. Does FATF permit simplification measures

Interpretive Note 5, paragraph 17(a) of the FATF standards provides that simplified due diligence may be appropriate where a client:

- is a designated non-financial business which is subject to requirements to combat money laundering and terrorist financing consistent with the FATF recommendations;
- has effectively implemented those requirements; and
- are effectively supervised or monitored in accordance with the standards to ensure compliance with those requirements.

This is in effect a potential widening of the opportunity to apply simplification measures, rather than a restriction.

The third directive, and it is anticipated the fourth directive, applies to independent legal professionals in a manner which is consistent with FATF standards and provides for effective supervision under those requirements. In principle any suggestion that independent legal professionals or other designated non-financial businesses should not have the opportunity to be subject to simplified measures at European level would be an admission of non-compliance with FATF standards by the directive and assumed non-effectiveness of the AML/CTF regime.

However, we appreciate that if Member States do not implement the obligations regarding independent legal professionals, then simplification measures would not be appropriate for legal professionals in that Member State.

If simplification measures are to be permitted, the question is what measures are appropriate in light of the risks and would produce a proportionate result. To make this assessment it is important to consider the nature of a pooled client account held by an independent legal professional.

4.4.2. Professional regulation of pooled client accounts

In the UK, a solicitor is required by law to have a separate client account to hold client monies, to keep full accounts of those monies, to have those accounts independently audited every year, and to provide that audit report to their regulator. A solicitor may not operate a banking facility or otherwise allow funds to pass through the client account without being involved in an underlying legal transaction relating to those funds. The relevant Law Society is also

entitled to audit or otherwise inspect a solicitor's accounts. Failure to comply with the relevant solicitors' account rules can result in disciplinary action, including striking off from the roll of solicitors. The sanction of striking off the roll is utilised, with 60 solicitors being struck off in England and Wales in 2011.

4.4.3. Practical and fundamental rights implications

In practice law firms will have hundreds to hundreds of thousands of clients each year. Many of those clients will be corporate entities and so will have a number of beneficial owners for the funds held. The funds held in pooled client accounts will be for retainers both within and outside of the remit of the third and fourth directives. Whose funds are held in a client account changes, not merely on a daily basis, but often minute by minute, because of the speed and volume of transactions. If a financial institution is required to identify the beneficial owners of client accounts, they would effectively be seeking lists of thousands of names each day, with no context other than the person having a retainer with a law firm. This will require significant resources from both financial institutions and law firms. Further, it is not clear what financial institutions should do with that information in order to meaningfully consider whether they have a suspicion of money laundering, as the information will be received in a vacuum.

Any decision not to allow simplified due diligence with respect to beneficial ownership of pooled client accounts held by independent legal professionals will also have fundamental human rights implications. The name of a client, while not being subject to legal professional privilege, is subject to confidentiality and may in Europe be subject to professional secrecy. Absent specific legal compulsion to provide the client names to the bank, a law firm would have to obtain explicit informed consent from each and every client and ultimate beneficial owner to provide their details to the bank. It is estimated that even if it only took 5 minutes to explain this to each client, this would result in an increase of hundreds to thousands of compliance hours per firm each year.

We have had recent legal advice that the wording in the third directive is not sufficient to compel the provision of the client's identity to financial institutions. There may well be a question as to whether the reporting of client names to financial institutions in the absence of any suspicion about the client and when the client account is already subject to external scrutiny is a disproportionate infringement on their right to privacy. Further the provision of information may in some circumstances contravene non-reporting orders issued by a court.

It may be suggested that instead of having large pooled client accounts, solicitors instead should or could open individual accounts for each client. Again this would require the client's consent and a significant increase in administrative burdens for both financial institutions and law firms.

4.5. Equivalence

To the extent that the fourth directive contains obligations or simplifications which can only be applied where there is equivalence, then the regulated sector will greatly benefit from provision of information on third country equivalence by the Commission. Whether the question of equivalence relates to AML/CTF laws or to markets and listing requirements, at some point it will be necessary to:

- obtain the legal requirements for each country or market;
- possibly have them translated; and
- take a view on whether they are technically equivalent.

Such an assessment could be undertaken by Member States who will usually have embassies or contacts in third countries and so easily obtain the relevant legislation or market listing requirements as well as translate the documents. Through coordination by the Commission, a consistent view could be taken on which factors need to be present in order for equivalent status to be awarded.

Alternatively the assessment could be left to the hundreds of thousands of individuals and firms which make up the regulated sector. We understand that in the UK there are 150,000 regulated entities. Of the 10,000 solicitors firm in England and Wales, over 80% are small to medium enterprises (SMEs) and we understand that this would be consistent across Europe.

The Law Society is aware that some of our members have undertaken this process for some jurisdictions under the third directive. We understand that this process has easily taken weeks to obtain sufficient information on the issue and at times involved considerable expense in instructing a foreign firm, just to establish equivalence for one jurisdiction. Even then, it is still not always possible for our members to confidently say that equivalence applied.

The vast majority of SMEs in the regulated sector will not have the resources to undertake this type of assessment; nor does it appear a good use of limited resources for firms to go through this process separately. However, due to the global nature of financial and legal services, even many SME law firms will legitimately have clients where use of the simplification measures would be appropriate.

Clearly, the involvement of Member States in this process is a more proportionate use of resources if the Commission wishes to realise the full benefits of the simplification provisions.

We appreciate that the Commission is concerned that some regulated entities may simply decide that all clients and transactions involving jurisdictions or markets on equivalent lists are low or no risk. We believe that the risk-based approach makes it clear that the list is merely a starting point in assessing the level of due diligence to apply to the client. It means that simplified due diligence may be available as there is a recognition that the client either poses a lower risk of money laundering generally or is otherwise subject to extensive due diligence obligations and there is a desire to reduce further duplication. However, the nature of the transaction or the source of funds may present a different level of risk for the specific transaction. The

regulated entity will need to consider these issues in deciding whether it is appropriate in any given situation to use the simplified due diligence or the reliance provisions which prima facie equivalence may allow. We believe that this can be made clear in either the recitals or the relevant articles of the fourth directive.

In terms of countries with poor AML/CTF standards, the Law Society does not believe that the Commission should expend resources in duplicating the work undertaken by FATF in this area.

5. Transparency in beneficial ownership

Regulated entities often find obtaining information about beneficial ownership a challenging and resource intensive aspect of their AML/CTF compliance. The Law Society welcomes efforts by Member States to improve the transparency of beneficial ownership of corporate bodies to assist regulated entities to comply with their obligations. However, such measures should carefully weigh the competing legitimate privacy concerns of beneficial owners and the proportionality of expectations placed on corporate bodies in providing extra information during these challenging economic times.

We support clarification in a fourth directive that the beneficial ownership threshold is established in all cases where the ownership interest is more than 25%, and that the natural person who is the ultimate beneficial owner must themselves hold the requisite level of interest in the client.¹

We do not believe the lowering of the threshold to 20% is proportionate, or that resources expended on ascertaining a further 5% in ownership will add to the detection of money laundering any more effectively than the current ‘control’ and ongoing monitoring provisions.

5.1. Companies

In implementing FATF Recommendation 24, the Law Society favours the following approach:

- All private companies and similar entities should be required to register details of their directors and their shareholders (or members where limited by way of guarantee) on a public register and keep the details updated.
- Nominee shareholders should be regulated and their nominee status noted in the share register. The nominee should keep the details of their nominators.

Access to such a public register could be charged at a nominal amount (for example in the UK access to the Companies House register is £1.50 a search) to help fund the register. Regulated entities then would be able to access details on the direct

¹ For example, if Company A is the client, and 30% of their shares are held by Company B, then for an individual shareholder in Company B to be a beneficial owner of Company A, they would have to own 84% or more of the shares in Company B to have the requisite interest level in Company A. It would not be right to say that every individual within Company B who owns shares is a beneficial owner because the company they are collectively a part of has the requisite interest.

shareholders, and where such a shareholder is a company with more than a 25% interest, they can follow the corporate chain through the public register to the ultimate beneficial owner, should one exist.

We believe such an approach is permitted by the Interpretive Note to Recommendation 24 and would be proportionate.

Impact Assessment

In terms of cost implications:

- A regulated entity would not be required to use the register and pay the fee for accessing the information; they could continue to ask for documents directly from the company. However this approach would save time, which in the case of the legal sector, would enable them to begin work and earning fees more quickly and more importantly target their resources to the real AML risks.
- In our 2008 survey over 90% of respondents would use a company registry to verify a corporate client if it were available. 42% of respondents said the lack of information available on beneficial owners was the greatest challenge in meeting their CDD requirements for companies.

We do not support:

- The requirement for private companies to hold and regularly update on a register the details of their ultimate beneficial ownership, as this is neither proportionate nor realistic in the face of modern legitimate business practices.
- The requirement to register publicly the details of all nominators, as this is a disproportionate infringement of their right to privacy and fails to adequately recognise the many legitimate reasons for holding shares through a nominee.

As bearer sharers are not a common feature of the UK corporate landscape we do not hold strong views on the FATF recommendation that such shares are banned. We are however aware that they feature heavily in other European Member States and their banning may have significant economic implications within those jurisdictions. We would however support moves to immobilise such shares so that they are held by a regulated financial institution or professional intermediary.

More details on our thoughts on how to effectively and proportionately ensure greater transparency in the beneficial ownership of companies can be found in our September 2011 response to FATF at pages 7 to 10:

<http://www.lawsociety.org.uk/new/documents/aml/fatfconsultation.pdf>

5.2. Trusts

In implementing FATF Recommendation 25, the Law Society favours the following approach:

- The use of existing law within Member States, who recognise trusts, to require trustees of express trusts to hold information on their beneficial ownership and to disclose that information to regulated entities.
- The creation of law within Member States, who do not recognise trusts, to require trustees operating within their jurisdiction to do the same.
- For regulated entities to maintain information on beneficial ownership of trusts with whom they have a business relationship in accordance with their AML/CTF obligations and for government agencies also to hold this information where relevant.

The Law Society does not support the creation of a trust register as it would be extremely costly and would disproportionately infringe on the right to privacy of many law abiding individuals across Europe.

More details on our thoughts on how to effectively and proportionately ensure greater transparency in the beneficial ownership of trusts can be found in our September 2011 response to FATF at pages 11 to 17:

<http://www.lawsociety.org.uk/new/documents/aml/fatfconsultation.pdf>

6. Data protection

The Law Society has a number of concerns with the proposed European regulation on data protection as it pertains to AML/CTF compliance, which we have been raising with appropriate stakeholders and would welcome the opportunity to discuss further with the Commission.

We are of the view that it is important that the fourth directive either gives full effect to the proposed Article 21, or specifically requires Member States to do so in relation to financial crime. The proposed Article 21 allows for data processing of personal data and sensitive personal data, refusal of data subject access requests and restriction of the right to be forgotten, when carried out for the purpose of preventing, investigating, detecting and prosecuting criminal offences. This is particularly relevant for law firms where the CDD information is only required under the AML/CTF provisions to be obtained for certain retainers but not for others. This result may expose our members to criminal sanctions for obtaining information in relation to a client on one retainer and then to criminal sanctions for not obtaining the information on the same client in relation to another retainer.

Full details of our concerns regarding the implications of the data protection proposals are available in **Annex 1** to this submission.

7. Group compliance

Within the FATF standards, group compliance requirements are limited to credit and financial institutions. While there are a large number of law firms which operate as global entities, the application of AML/CTF provisions to lawyers, especially outside of Europe are quite varied. Accordingly law firms often need to be flexible in their approach to applying global standards and we would not support mandating global standards for law firms.

Equally, we would be concerned if the fourth directive precludes the transfer of information within an organisation unless they are a financial group and have global standards.

The prohibition on disclosing the fact that a report had been made to the client or a third party originated at a time when there was very limited trust by law enforcement about the cooperation of the regulated sector in preventing money laundering and counter-terrorist financing. Since that time it has become apparent to law enforcement, Member States and the Commission that there are situations where sharing details of a disclosure are not only relevant but can be very helpful, resulting in an extensive list of exemptions. The Law Society believes that sharing information on suspicious transactions within an organisation and with external auditors (who will also be regulated for AML/CTF compliance) would be other examples of situations where such sharing of information could assist in the fight against financial crime.

The Commission may continue with the approach of adding more exemptions, although this risks being unresponsive to future developments. Alternatively the Commission could reconsider this provision in light of the conduct it really aims to prevent: namely disclosures which may prejudice investigations and the safety of individuals making the disclosure. Provided there is a legitimate interest in the information being shared, appropriate confidentiality provisions in place and the disclosure is not likely to prejudice an investigation, we believe the disclosure should be permitted.

8. Role of FIUs

The Law Society supports reinforcing the requirement for FIUs to provide feedback to the regulated sector.

From our experience, we believe the most effective feedback is through sector specific methodologies and public reporting of arrests, convictions, sentences and confiscation amounts.

While individual reporters will always value individual feedback, this will not increase the engagement of those who are not reporting, improve the quality of reports from across the regulated sector or help the regulated sector appreciate the value of the intelligence obtained from their reports.

In principle we are broadly in favour of increased cooperation between FIUs. However, within the UK we have very high standards around the confidentiality of reports made to the FIU and training of individuals within law enforcement who are entitled to have access to the reports. Our law enforcement agencies and courts demonstrate a high

respect for the rule of law and reporters can be quite confident that they will not be subject to official reprisals as a result of the contents of their reports. We appreciate that unfortunately this is not the case in all jurisdictions and we believe it is crucial that FIUs retain the discretion to withhold information from other FIUs where there are concerns about confidentiality breaches or possible reprisals against reporters.

The Commission asks whether there should be an explicit requirement that reports be made to the host country FIU, rather than automatically being required to be made to the FIU in the jurisdiction where the head office is located. From a legal sector perspective, where clients and law firms are based in different jurisdictions, or where different offices of the firm are involved in parts of the same retainer in which a suspicion arises, it may be appropriate for multiple reports to be made. However we agree that it would be an unproductive use of resources, both for law enforcement and the regulated sector, if a head office has to submit a report to the home FIU simply because a branch office has filed a report and the firm has a central database of reports or if information about reports is shared within the organisation. Further clarity on this issue would be desirable.

9. Role of supervisors and self-regulatory bodies

The Law Society is very supportive of the inclusion of SRBs in the supervisory framework set out in the revised FATF standards and believes this should be fully incorporated into the fourth directive. SRBs are in a good position to understand their sectors and the risks they face in more detail than law enforcement or generic supervisors. SRBs are also likely to have closer relationships with regulated entities within their sector and will be able to more effectively undertake awareness raising and educational activities. Finally, where SRBs have powers to monitor, investigate and discipline regulated entities, they will be able to look at the totality of the conduct of the regulated entity and take appropriate action against both the entity as a whole, as well as individuals within the entity.

10. Sanctions

The Law Society agrees that, consistent with principles of better regulation, it is important that there is a full range of sanctions available to enforce the AML/CTF obligations proportionately and effectively.

The third directive has two parts to the regime as far as it relates to the regulated sector: firstly the requirement for due diligence and systems which enable a regulated entity to assess whether money laundering may be occurring, and secondly the requirement for the regulated sector to help prevent money laundering through their reporting obligations.

For the first part of the regime, FATF has recognised that this is a risk-based approach and that both supervisors and competent authorities in assessing compliance must give due regard to the level of discretion which is provided by the regime to regulated entities. In some cases the failure to comply with due diligence obligations will be inadvertent and will not lead to money laundering. In other cases, even where there was a failure to undertake due diligence in full, a suspicious activity report was still

submitted. If the Commission is to take steps to set minimum sanctions, the fourth directive should explicitly reflect the fact that the due diligence obligations do not exist within a zero failure regime and that the range of sanctions should allow for a proportionate response to the actual risks generated by the regulated entity's conduct and the culpability involved in the breach.

We would however caution against being too prescriptive about the approach which Member States should apply. The regulated sector is quite broad, with some regulated entities being supervised only for AML/CTF compliance and others, such as legal professionals, being supervised for all aspects of their work. The wide variety in sizes, turnover, market presence and reputational factors for regulated entities in different sectors will mean that a sanction which is effective and proportionate for some is quite disproportionate for others.

Annex 1 – Fighting financial crime in light of EU data protection proposals

Processing of personal data to comply with a legal obligation

The UK Money Laundering Regulations 2007 only require solicitors to collect and process personal data on their clients and beneficial owners where they are advising in the regulated sector (which generally encompasses property, commercial, tax, trust and probate work).

The Money Laundering Regulations 2007 themselves do not state what personal data needs to be collected. Rather they merely provide that the:

- client must be identified and verified;
- ultimate beneficial owners must be identified and then verified on a risk-based approach; and
- source of funds must be established where relevant.

Industry issued and HM Treasury approved guidance provides more detail on the types of data which should be collected, although firms have discretion as to the specific type and amount of data collected in accordance with the risk-based approach.

Most firms will have a standard client intake procedure, and will conduct due diligence on all clients so that the client is able to instruct the firm on both regulated and unregulated matters, with minimum disruption and delay.

The Money Laundering Regulations 2007 also require solicitors to monitor business relationship which requires a scrutiny of transactions undertaken by the client during the course of the relationship. This may well involve the collection and processing of personal data of counterparties as well as the client. Further there are requirements to apply enhanced due diligence and monitoring when clients or transactions are perceived to be higher risk. Finally solicitors are required to establish and maintain appropriate and risk-sensitive policies and procedures on customer due diligence measures and ongoing monitoring.

Under the proposed EU data protection regulation (the Regulation) it is not clear how widely the processing condition in order to comply with a legal requirement will be interpreted.

Issues needing clarity in this area include:

1. Will the mere requirement under the Money Laundering Regulations 2007 to identify and verify and monitor individuals and transactions be sufficient to engage the processing condition of “in accordance with a legal requirement” or must the law explicitly state the types of personal data which may be processed?

2. If there is a need for specificity, would the adherence to industry developed and government approved guidance on the extent of personal data needed be sufficient?
3. Will this processing condition apply to situations where the processing of personal data is not a specific legal requirement but is a means of avoiding engaging in the prohibited conduct? For example UK Sanctions legislation does not specifically require solicitors to screen clients, beneficial owners or counterparties for the purposes of establishing that they are designated persons. Equally the UK Proceeds of Crime Act 2002 and the counter-terrorist financing regime prohibits conduct but does not specifically provide for the collection of personal data.

If the processing condition is to be interpreted narrowly so that the law must specifically require the data to be collected in a given circumstance, law firms will need to rely on another processing condition to obtain personal data when acting for a client outside the regulated sector or to comply with their obligations under the sanctions and counter-terrorist financing regimes or to meet their own internal risk-based procedures which may go over and above strict national legal requirements but are still necessary to meet global requirements.

Where solicitors are processing personal data on a processing condition other than that relating to compliance with a legal requirement, they may find themselves in the difficult position of facing criminal sanctions if they don't get the information when a client instructs them on a regulated retainer on one hand and breaching the data protection regulation if they do get the information when the client instructs them on a non-regulated retainer.

It is also not clear what processing would be permitted if a client was instructing on both types of retainers simultaneously.

Further, under the proposed Regulation data is only permitted to be collected for a specified purpose and not processed in a way incompatible with that purpose.

This can cause difficulty where such contact and identity details are collected outside the regulated sector (and therefore not in reliance of the legal requirement conditions), but during the retainer a suspicious activity report needs to be made. It is not clear whether such data, obtained in such a manner, could be processed in this way.

The Proceeds of Crime Act 2002 does not specify in detail the personal data which must be provided in a suspicious activity report. However, law enforcement have indicated that the provision of a simple mobile phone number in such a report can assist in opening up avenues of investigation into a whole new section of an organised crime gang of which they were not aware.

The enactment of restrictions under Article 21 of the proposed Regulation, particularly in respect of the prevention, investigation, detection and prosecution of criminal offences may alleviate some of these complications.

Issues with consent

- Processing for more than one purpose. Basic identity information about direct clients is generally obtained in discussion with clients and much of it may be necessary for the purposes performing the contract or necessary for the legitimate interest of the data controller. Therefore consent will not be required (or may be implied). However, the definition of consent under Article 4 of the Regulation requires consent for all processing to be explicit (not just, as under the UK Data Protection Act, for sensitive personal data). Where solicitors wish to process data for general prevention of crime (or in circumstances outlined above where the condition relating to legal requirements does not apply) it may be that the information has been obtained from sources other than the client and so obtaining explicit consent in these circumstances may be difficult (as further explained below).
- Ultimate Beneficial Owners. A significant amount of due diligence work relates to identifying and verifying ultimate beneficial owners. In most cases these individuals will have a controlling interest in the direct client through shares, but will be far removed from the day to day transactions on which the direct client is seeking advice or assistance.

Currently the identify information about these data subjects will be obtained from official registries, public sources or from the direct corporate client. In the latter case, the corporate client consents through the terms and conditions to providing information on its employees and owners. At present often no contact is made between the law firm and the ultimate beneficial owner who is the data subject – and therefore explicit consent will be difficult to establish. Where the information sought goes beyond that permitted by the requirement for complying with a legal obligation, and the legitimate interest condition cannot be applied, the requirement to obtain explicit consent from the data subject will involve considerably more cost and inconvenience to the law firm, the client and the ultimate beneficial owner, as well as delay the provision of legal services to the direct client.

Again the enactment of restrictions under Article 21 of the proposed Regulation, particularly in respect of the prevention, investigation, detection and prosecution of criminal offences may alleviate some of these complications.

Sensitive Personal Data

Sensitive personal data such as ethnicity, political opinions, and criminal history can all be relevant pieces of information when firms are considering their compliance with enhanced due diligence provisions for politically exposed persons (PEP), counter-terrorist financing obligations, anti-bribery obligations and sanctions lists.

The enhanced due diligence obligations extend to direct clients who are related to a primary PEP or are a close business associate to the PEP. The PEP themselves may

have no contact whatsoever with the specific retainer being undertaken by the client, but their sensitive personal data is relevant to how the direct client is to be dealt with by the firm. Generally such information is obtained from public sources or third party information providers. Obtaining explicit consent from the PEP to process such data is often difficult.

Both the sanctions regime and the counter-terrorist financing regime apply to the provision of economic resources or funding either directly or indirectly to individuals. As such the political opinions and affiliations, criminal convictions and investigations, and listing on a sanctions list of data subjects, other than the direct client, may be directly relevant to compliance with the law. While the solicitor may have discussions about the data subject with the direct client, it is highly unlikely that they would be in contact with the actual data subject in order to obtain explicit consent.

Will the processing head of requirement to comply with law or regulation be interpreted sufficiently widely to allow this type of sensitive personal data to be processed, even for retainers outside the regulated sector?

Fair processing information and information about security breaches

We agree that it is important that any processing of personal data is fair, as is currently required. However under the proposed Regulation what constitutes fair processing has been extended.

One example of this extension is the need to tell the data subject how long you will store the data. This is difficult in an AML context as the solicitor is required to hold it at least five years after the business relationship ends. Under the Money Laundering Regulations 2007 the business relationship is formed and ended in accordance with the law firm's views, not the data subject's views. Further, the period may be longer if there is a subsequent investigation by law enforcement or regulatory bodies.

Will it be sufficient to provide a general statement that personal data it will be stored in accordance with legislative requirements?

As with the current provisions, there is a proposed requirement to provide fair processing information to data subjects. Although solicitors are clearly able to provide this information to clients with whom they have direct contact, it is much harder to provide this fair processing information to beneficial owners or other individuals outlined above on whom personal data is processed without them being contacted. Under the current provisions there is an exemption which allows processing for the purpose of the prevention of crime without informing the data subject, which is often utilised with respect to beneficial owners. The continuation of such a restriction would help alleviate some of these complications.

The new proposed requirements relating to security breaches mean that an entity must inform the Information Commissioner whenever there is a security breach (regardless of importance) within 24 hours and to inform the data subject where the breach is serious. It is not clear how these provisions would work within the context of AML processing

where data subjects may not be aware that information is held on them and where the nature of the information held may be sensitive.

Right to be forgotten and data subject access

The proposed Regulation creates a new right to be forgotten. However under the Money Laundering Regulations 2007 all records relating to the client must be retained for five years after the end of the business relationship. If a firm complies with the right to be forgotten requirements by destroying personal data they hold on a client, if the client has ever instructed them on a regulated matter, they will be in breach of the Money Laundering Regulations 2007 and facing a criminal sanction.

Proposed Article 17(3) of the Regulation allows for erasure to be refused for compliance with a legal obligation; however this could be complicated where a client has instructed on both regulated and unregulated work. It could also leave firms in a difficult position with respect to demonstrating their compliance with the sanctions regime and the counter terrorist financing regime, as there is no specific data retention obligations contained within those provisions.

The proposed provisions for rights of access are essentially consistent with the current requirements; however there is no longer the specific exemption for prevention of crime. This could place law firms in the very difficult situation of being asked to provide information about making suspicious activity reports about suspected money laundering and terrorist financing. This could mean that the law firm is in breach of the non-disclosure provisions under the relevant AML/CTF laws and could also put the staff members of the law firm at risk of physical injury.

The enactment of restrictions under Article 21 of the proposed Regulation, particularly in respect of the prevention, investigation, detection and prosecution of criminal offences for each of these provisions may alleviate some of these complications.