



The Law Society

## **From the President**

Rt Hon Stephen Timms, MP  
Chief Secretary to the Treasury  
HM Treasury  
1 Horse Guard's Rd  
London SW1A 2HQ

11 January 2007

Dear Mr Timms

### **Implementation of the Third Directive on Money Laundering**

I write further to the meeting between HM Treasury officials and representatives from both the Law Society of England and Wales and the Society for Trusts and Estates Practitioners (STEP) on 8 December 2006, regarding the implementation of the Third European Directive on Money Laundering into English law.

Further to those discussions we have sought legal advice on the practical difficulties associated with the adoption of the current definition of 'beneficial ownership' as it stands in the Directive, into domestic regulations. We set out in the enclosed appendix a number of scenarios which outline the difficulty in applying that definition within an English context and illustrate the opportunity for different practitioners to come to different views as to when, and to what extent, customer due diligence (CDD) should be conducted in any given situation.

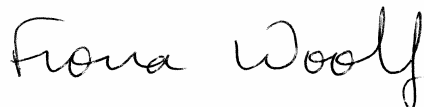
Such uncertainty is undesirable for two reasons: firstly because it will lead to inconsistent application of the Directive; and secondly because it will leave even the most conscientious of practitioners open to severe criminal sanction. Put simply, it is not acceptable for the government to pass the responsibility of interpreting the opaque language of the Directive to practitioners.

The additional expense created by the extended CDD on trusts will inevitably be passed on to clients. Those providing services to trusts, including banks, brokers, fund managers, investment advisors, estate agents, lawyers, accountants and other professionals, will be required to undertake checks to establish the identity of the beneficiaries and then to verify those persons. This will be even more difficult for those providing services to non-resident trusts. Because of the uncertainties over the requirements the additional checks undertaken are likely to be applied unevenly and may be undertaken excessively out of over-caution.

As can be seen from the analysis contained in the appendix, the difficulties associated with applying the definition of beneficial ownership contained in the Directive to English law are not insignificant and apply to even the most common and simple forms of trusts utilised in this country.

The Law Society strongly urges HM Treasury to review the drafting of the definition in the Regulations to provide greater clarity in the English context or to provide clear guidance within the Regulations with respect to when and how the definition is satisfied. The Law Society will continue to raise this issue, in the interests of our members, in the hope of achieving the implementation of the Third Directive into English law in a manner which is both workable and proportional to the money laundering risks actually posed by the majority of trusts.

Yours sincerely

A handwritten signature in black ink that reads "Fiona Woolf". The signature is written in a cursive, flowing style.

Fiona Woolf CBE  
President

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# Appendix

## The Ownership Test

### 1. Successive Interests

T dies, leaving his estate on trust for his widow for life and on her death, to their four children in equal shares. This is not an unusual form of will. At some point the trustees will want to open a bank account. The bank will have to conduct CDD, but on whom? Evidently CDD would be conducted on the trustees at a minimum. What about the beneficiaries? Each of the children will sooner or later take 25% of the estate but only when the widow dies. Until then, each has actuarially less than a 25% interest. Conversely, the widow's rights, if she is young, may be valued actuarially at more than 25% of the whole estate; and then the children will have less than 25% each. This would be so even if there were only three children.

So the bank will have to decide whether it does CDD on:

- The trustees alone; or
- The trustees and the children; or
- The trustees and the widow; or
- All of them.

There is at first glance a theoretical case for saying that the answer will always be "on all of them". Each of the children and the widow has rights in the whole estate. As a matter of English trust law, each is a beneficiary of 100% of the property in the trust, never mind 25%, in that each has rights in it. The same would be true if there were a dozen children. However, it is clear that the Directive was not written with the technicalities of English law in mind. Besides, the 25% limit would then be irrelevant, as a beneficiary of every trust where the future beneficiaries have already been determined would have an interest in the trust property. So instead the Directive must require asking whether there is some individual who by themselves beneficially owns 25% or more of the trust property.

The question is, how then is that individual or individuals identified. More than one approach is available.

#### **No beneficial owner of any percentage**

One option is to say that no one is the outright beneficial owner of any percentage share in the property. The widow gets the income only, but cannot call for a transfer of any of the underlying property; the children will each be able to call for 25% of it, but not yet. So neither the widow nor any of the children is a beneficiary of the trust property. That would be a surprising result, but the difficulty is to find an alternative.

#### **Ultimate division of estate**

Another option is to ignore the widow's interest and look only at the ultimate division of the estate. In civil law countries there is one owner of property (or several joint owners) and though others may have rights, including a life interest, the ultimate owner is still seen as the owner of the whole. Lawyers with that outlook would be likely to treat the eventual recipient as the owner and, where there is more than one, ask

whether he/she will take 25% or more. The trouble with that approach is that it would hardly occur to an English lawyer that the widow should be ignored in favour of the children and the Directive contains nothing to say that this should occur. It would be odd to put the present owner to one side when the children may take nothing for many years. Further, the Directive does not obviously invoke that civil law of ownership.

### **Actuarial approach**

The final option is to take an actuarial approach, valuing each person's rights rather than the property itself. English lawyers are used to the idea that ownership may be divided by time, so that you have a limited owner followed by one who has to wait. If you ask whether either has 25% or more, only an actuarial answer is possible. The trouble with that approach is that beneficiaries will slip back and forth across the 25% limit accordingly to whether the widow gets significantly older or contracts a life-threatening disease. "Ongoing monitoring" would presumably compel banks to call for actuarial reports as circumstances change, thereby increasing compliance costs.

None of these approaches seem to be particularly desirable, nor is there clear instruction from the Directive as to which approach is intended.

## **2. Contingent Interests**

Alternatively, T dies, leaving his estate to the grandchildren alive at his death if they reach 25 years of age, in equal shares; and if none survive, then to a charity. The grandchildren are three boys, all young. Are they beneficial owners within the meaning of the Directive?

Each grandchild will eventually take more than 25% of the trust property, if he survives. In the meantime, the trustees will usually have discretion to pay out some of the income of his prospective share for his benefit, accumulating any balance. In accordance with the Trustee Act 1925, once he has reached 18 they will have to pay him the income until he either reaches 25 or dies beforehand. They will also usually under the Trustee Act 1925 have discretion to pay him some of the capital before he reaches 25.

The Directive is obscure on the treatment of such cases. Once we have discarded the idea that it is enough to say that each of the three is a beneficiary of the whole, we have to look for some other approach. The same three choices apply as before, but produce slightly different results:

### **No beneficial owner of any percentage**

Again, no one is the outright beneficial owner of any percentage share in the property, a proposition more clearly true than in the previous example.

### **Ultimate division of the estate**

Looking at the ultimate division of the estate does not produce a clear answer. Each grandchild may take a third if he lives until 25 or he may take nothing.

### **Actuarial approach**

An actuarial calculation is again possible, but will produce different answers according to the time when it is made. At some point the value of each boy's interest will pass the 25% limit, but when such calculations should be made is not clear.

### 3. Discretionary Trusts

Different problems are raised by discretionary trusts. A common form of trust is in favour of children and remoter issue of the settlor, together with the spouses, widows and widowers of those people; even cousins may be included. The trustees are generally given a very broad discretion to decide who gets what and when they do so, so that no one has an identifiable interest until they exercise their powers. Large families may produce several dozen existing beneficiaries, with more to come in the shape of those unborn (future children) or unascertained (future spouses). On the other hand, a discretionary trust might be limited to, say the settlor's existing three children.

The Directive initially appears to give some guidance to these types of trusts. In its preamble, it says that it will be enough to identify the class of persons intended to be the beneficiaries where the individual beneficiaries are yet to be determined and it is therefore impossible to identify an individual as the beneficial owner. In the body of the Directive, the beneficial owner is to include:

- where the future beneficiaries have already been determined, the natural person(s) who is the beneficiary of 25% or more of the trust property; but
- where the individuals that benefit from the trust have yet to be determined, the class of person in whose main interest the trust is set up or operates.

Evidently there is meant to be some form of concession to practical considerations, but it is difficult to know how far it goes.

The definition assumes that there will be two sorts of trusts, one where the future beneficiaries have already been determined and one where the individuals that benefit have yet to be determined. But those are not the categories of English law. A trust has to have at least one beneficiary to be valid, though he or she does not have to have a fixed interest and may be merely a member of a class who can be benefited as a matter of discretion.

In the first example of a discretionary trust above, there are numerous children and grandchildren and until the trustees decide to give something to one or more of them, presumably it is true to say that the individuals that benefit from the trust have yet to be determined and so they fit within the second part of the definition. But is that equally true of the second example of a discretionary trust, where the class consists of only three children? Each of the children may end up with nothing, if the trustees decide to give everything to one or both of the other two, yet collectively they own the whole of the trust property.

Once the trustees start to exercise their discretion, a trust will straddle the two categories. They may decide to give a third of it to a grandchild if he or she reaches 30 and make an irrevocable appointment to that effect. If the grandchild is now 15, we are back to the uncertainties about the treatment of contingent interest so far as that beneficiary is concerned. So far as the rest of the class is concerned, it is no longer true to say that the individuals that benefit from the trust have yet to be determined, since one of them has just been determined. But is the result that no CDD on them is needed or is the exercise of discretion to be ignored.

As the definition stands, the resolution of these problems is not clear.

## **The Control Test**

Control is an idea which figures more than once in the definition of beneficial owner. Firstly, someone who controls the settlor (particularly where the settlor is a corporate entity) is a beneficial owner, and secondly in the case of a trust, the beneficial owner includes the natural person(s) who exercises control over 25% or more of the trust property.

It is the latter provision which is the main source of uncertainty. The trustees exercise day-to-day control over trust property, in the sense that they administer it and may be given discretion about its ultimate recipients. However, no English lawyer would, on that basis alone, consider that they constituted a beneficial owner of the trust property. However there are other candidates for the role of controller.

### **1 Power of Appointment**

A third party is commonly given a discretionary power to dispose of trust property in favour of beneficiaries, namely a power of appointment. The power is conferred by the trust instrument and the trustees have to give effect to it. It may extend to the whole trust property or to only a part, for example, the power to appoint a life interest in favour of a widow. The ultimate destination of some or all of the trust property may therefore depend on such a decision. The holder of the power may or may not be authorised to appoint the property in favour of him or herself.

### **2 Reserve Powers**

The settlor will commonly reserve to them self the power to appoint new trustees when needed, and may also reserve a power to sack the existing trustees and replace them. If the settlor does so, or even if they do not, they will indirectly have a substantial measure of control over both the administration of the property and the exercise of any discretionary powers given to the trustees.

### **3 Powers of Protection**

A bundle of powers of veto may also be given to a person known as the "protector", perhaps a family friend. This means that some or perhaps many of the trustees' powers may be exercised only with the protector's consent. The protector may, for example be able to veto a proposed exercise of powers in a discretionary trust. As such the protector may also have a substantial measure of control over the trust property.

Whether any of these persons are to be regarded as having control of trust property is not clearly answered by the definition of beneficial owner contained in the Directive.