Joint Consultation Paper - European Banking Supervisors' Guidance on EDD and SDD for 4MLD

Joint Guidelines under Article 17 and 18(4) of Directive (EU) 2015/849 on simplified and enhanced customer due diligence and the factors credit and financial institutions should consider when assessing the money laundering and terrorist financing risk associated with individual business relationships and occasional transactions

The Law Society is the professional body for the solicitors profession in England and Wales, representing over 160,000 registered legal practitioners. The Society represents the profession at parliament, government and regulatory bodies and has a public interest in the reform of the law.

This response has been prepared by the Society's Money Laundering Taskforce which is pleased to be able to contribute to this consultation exercise.

The Money Laundering Task Force (MLTF) has a longstanding and distinguished record of working alongside government and law enforcement in the development of AML policy, legislation and working to improve the UK’s AML regime.

In addition, the MLTF's work on the international stage has earned it a brand of worldwide standing extending much further than just the legal sector. The MLTF is regularly invited to contribute to policy development discussions at both FATF and EU level.

In our response to this consultation, we wish to focus primarily on the section relating to simplified due diligence (SDD) and pooled accounts as this issue has been the focus of our representations throughout the passage of Directive (EU) 2015/849 (4MLD) and during the process of its transposition into UK law.

The application of simplified due diligence to pooled client accounts

While the Law Society is generally supportive of 4MLD, there is an area of concern to the legal profession which, if applied inappropriately by member states and financial institutions, will have unintended consequences for EU citizens' access to justice and to the daily operation of banks and other legitimate businesses through a resultant requirement to undertake disproportionate compliance activities. The Law Society strongly advises the Member States to continue to allow the application of simplified due diligence by financial institutions in relation to pooled client accounts ('PCAs') held by independent legal professionals.

PCAs are accounts used by legal professionals that are held with a financial institution. The purpose of these accounts is to hold client monies 'on trust' or for a purpose designated by the client. Money will either be held or received for the payment of costs incurred by the legal professional on behalf of the client or for specific transactions on which the legal professional is advising. No funds should pass through a client account without it being involved in an underlying legal transaction.

Under the current UK legislation[1], the 3rd EU Money Laundering Directive[2] and the FATF 2012 Recommendations[3], financial institutions are explicitly allowed to apply SDD to these accounts as both the financial institution and the legal professional are obliged entities required to have anti-money laundering systems in place and are effectively supervised in accordance with the FATF Recommendations.

The Law Society believes that PCAs should continue to be explicitly regarded as a low risk under the updated AML legislation of EU Member States as there have been no changes in the nature of PCAs and there have been no events or data to suggest that PCAs constitute a high risk of money laundering. Consequently, under the revised FATF standards, which provide the basis for the 4MLD, PCAs continue to be seen as low risk. The change in FATF standards is only that PCAs now fall within a wider low risk category instead of being an explicit 'exemption'. The new low risk criteria provides that where an entity is subject to and has implemented money laundering requirements and is effectively supervised in accordance with the FATF Recommendations it can be treated as low risk[4]. We believe this should continue to be reflected in the updated UK regulations, and those of other Member States, following the transposition of 4MLD.

The justification for treating PCAs as low risk are as follows:

- A legal professional is an obliged entity required to have anti-money laundering systems in place and is effectively supervised in accordance with the FATF Recommendations.

- A legal professional 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. Accordingly there are already controls in place in which the solicitor understands who is entitled to the money in the accounts.

- A legal professional may not operate a banking facility or otherwise allow funds to pass through the client account without it being involved in an underlying legal transaction relating to those funds. It is the transaction on which the legal professional is advising which will determine whether or not there is a risk of money laundering in respect of the funds being paid into the PCAs. The simple provision of names to a financial institution as to who has paid sums into the account will not assist the bank in understanding if there is a money laundering risk; it is only knowledge of the underlying transactions that would assist in this, and this is addressed by the fact that the legal professional is under an obligation to report any suspicions in relation to the transaction on which he/she is advising.

- During our lobbying in Brussels on 4MLD we outlined that the removal of the specific reference to PCAs as being low risk could lead to inconsistency in the application of anti-money laundering rules both within the EU and vis-a-vis third countries. Some Member States may now assume, incorrectly, that the removal of the specific

1 UK Money Laundering Regulations 2007, Regulation 13(4)

2 Directive 2005/60/EC (the '3rd Directive'), article 11(2)b

3 The FATF Recommendations, Interpretive note to recommendation 10, paragraph 17 (a)

4 ibid

reference indicates that PCAs are no longer regarded as low risk and therefore may not permit financial institutions to apply SDD measures in these circumstances. While the EU Parliament understood our concerns and supported an amendment to their text reinstating PCA's to the list of vehicles suitable for SDD, our amendment did not survive the trilogue negotiations and does not appear in the final 4MLD text. In our correspondence with the EU Commission we were given assurances that the reason for the specific exemption for PCAs being omitted from the Commission text of 4MLD was to enable member states to take a risk-based approach and decide which vehicles were appropriate for SDD, rather than giving any indication of perceived added AML risk associated with PCAs. In other words, it is clear that Member States have the ability to retain PCAs' current status within their updated AML legislation whilst still meeting obligations under 4MLD and the FATF 2012 Recommendations. Application of a risk-based approach ensuring risks are accurately assessed should be the goal for both banks and law firms. The Society supports the risk-based approach to anti-money laundering obligations as it enables the obliged entities, including the legal profession, to focus their resources where the risk is higher, thus making the system more effective overall.

If financial institutions are unable to continue to apply SDD to PCAs it will lead to the following problems:

- As the funds are held “on trust” or “to the account” of clients of a firm, the financial institution may feel obliged to treat the latter as beneficial owners of the PCAs. In practice law firms may have hundreds/thousands of clients each year. The funds held in PCAs change, not merely on a daily basis, but sometimes minute by minute, due to the speed and volume of transactions. If a financial institution is required to identify the beneficial owners of PCAs, they would effectively be seeking information about the funds held by hundreds (or possibly thousands) of law firm clients each day, in order to establish whether, on that given day, they might be considered to be a beneficial owner, with no context other than the persons concerned having a retainer with a law firm. This will require significant resources from both financial institutions and law firms, with limited added benefit in terms of the fight against money laundering.

- If banks are subjected to disproportionate compliance activities with respect to PCAs, the profit margins on these accounts will reduce significantly. Such situations are the key drivers of the bank de-risking phenomenon which is one of the greatest challenges faced by FATF and its member countries today. If the banks began to consider these accounts to be too risky for the associated reward and no longer allow them to exist there would be significant implications for the way solicitors operate and flow-on effects for the property market and EU citizens' access to justice.

- It is possible that, if PCAs are de-risked out of existence, solicitors would be required to open an individual account for each of their clients. This would result in further duplication of compliance activities by law firms and the banks with no added benefit in the fight against money laundering.

It is clear to the Law Society that there are compelling reasons for all parties to continue to allow SDD to be applied by financial institutions to pooled accounts after the transposition of 4MLD by Member States.

We are therefore pleased that this draft guidance document seeks to enable banks to continue to apply SDD to PCAs under 4MLD.

Content of Joint Guidelines

Our overall view of the guidelines as they apply to PCAs is that they incorrectly focus on ensuring proper CDD has been undertaken rather than on the purpose of the client account and the underlying transaction which gives rise to its use.

The Law Society would support the move toward an approach that is more focused on the use of the client account. As mentioned above, while law firms are required to perform robust CDD on clients wishing to undertake activities regulated for AML, it is the transaction on which the legal professional is advising which will determine whether or not there is a risk of money laundering in respect of the funds being paid into a PCA.

The suggestion that banks could 'sample-test' a firm's PCA fails to take into account the fact that some clients will use a firm's PCA to instruct on work which is outside the matters specified in Article 2(1)(3)(b) of 4MLD. The Guidelines as currently drafted could imply an obligation to apply AML rules on all clients, even those instructing on non-regulated work (outside the scope of 4MLD).

CDD information should only be requested by a bank in respect of those who use the PCA for regulated work, and only then if the bank has a concern about a particular transaction.

With respect to the specific wording of sections 108, 109 and 110 relating to pooled accounts we would make the following observations:

> *Section 108: The Bank may apply SDD if:...*
>
> *"the ML/TF risk associated with the business relationship is low,* ***based on the bank's assessment, of its customer´s business, the types of clients the customer's business serves and the jurisdictions the customer's business is exposed to****, among others; and"*
>
> We would suggest this could be re-worded to make clear that a copy of the customer's AML risk-assessment made available on request would be sufficient to satisfy this condition. This document would give a picture of the risks faced by the customer if the bank assessed the customer as high risk after applying a risk-based approach. All EU law firms will be required to have a written assessment of their money laundering risks available under 4MLD and most already do.
>
> *"the bank is satisfied that the customer applies robust and risk-sensitive CDD measures to their own clients and their clients' beneficial owners….".*
>
> As mentioned above, this could imply an obligation to apply AML rules to all clients, even those instructing on non-regulated work.

Accordingly, we would suggest this as an alternative form of words:

“the bank is satisfied that the customer applies robust and risk-sensitive CDD measures to their own clients and their clients’ beneficial owners as required under the AML/CTF obligations in the EEA state in which the customer operates.”

Section 109: SDD measures may consist of the bank:

*"....**identifying and verifying the identity of customer, including the customer’s beneficial owners;"***

The application of SDD means that banks are not required to apply CDD to the third party beneficial owners of PCAs held by solicitors, provided the information on the identity of the beneficial owners is available upon request. The first bullet point under section 109 identified above is incompatible with the application of SDD.

Alternatively, if this paragraph is intended to refer to the beneficial owners of the law firm in the sense of the individuals who have a relevant equity interest in the firm (rather than the underlying clients), we would suggest that this is clarified as we believe that there is otherwise scope for confusion as to whether this is intended to refer to those individuals or to the firm's underlying clients.

Section 110:

"Where the customer is established in a third country that has been identified as high risk under Article 9 of Directive (EU) 2015/849, firms providing retail banking services shall apply EDD measures"

We would suggest that reference is included here to the second limb of Article 18(1) of 4MLD, which provides that enhanced due diligence (EDD) measures need not be invoked automatically with respect to branches or majority-owned subsidiaries of obliged entities established in the Union which are located in high-risk third countries, where those branches or majority-owned subsidiaries fully comply with the group-wide policies and procedures in accordance with Article 45.

Public Hearing

The Law Society attended the public hearing on the draft Guidelines, which took place at the EBA premises in London on 15 December 2015.

During the hearing, a question was raised as to whether banks must automatically apply EDD measures to sectors identified as high risk in National Risk Assessments undertaken by Member States.

The Joint Committee of the three European Supervisory Authorities responded by stating that pursuant to Article 8 (3) of 4MLD, banks must mitigate and manage effectively the risks identified at the level of the Union, the Member State and the bank itself. However, crucially, the Joint Committee stated that it is the risks identified by the bank that should be considered paramount, over and above those identified at Union and Member State level.

It was requested by delegates at the public hearing that this statement be made clearly within the Joint Guidelines document.

National Risk Assessments are general in nature and will vary considerably between Member States in terms of rigour, prudence and candour. We believe it is essential for a bank's considered view of the specific risks it faces to be held in higher regard than the more general assessments made at Member State and Union level.

The Law Society would like to reiterate its support for both the bank's risk assessment being paramount, and for this to be made clear in the Joint Guidelines document.

Conclusion

The Law Society is committed to working with the British Bankers Association and European banking supervisors to ensure the SDD guidelines with respect to PCAs are clear, workable, proportionate, risk-based and avoid unnecessary processing by either party.

While we appreciate being granted the opportunity to make this formal submission regarding the EBS Guidance we would welcome a bilateral meeting with representatives of the EBS to explain our position in greater detail.

The Law Society's Money Laundering Taskforce
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