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The UK Government's final steps to implement 4MLD

In a busy month for regulatory developments in the area of anti-money laundering ('AML') and countering the financing of terrorism ('CFT') in the UK, HM Treasury published its response to the consultation on the Transposition of the Fourth Money Laundering Directive ('4MLD') together with draft legislation, and a draft of the new Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 ('MLR 2017'), among other things. These developments represent the UK Government's final steps to implement 4MLD in the UK, and include additions to the AML supervisory regime. Guy Wilkes, Partner at Mayer Brown International LLP, discusses the proposals put forward.

On 15 March 2017 HM Treasury published its response to a consultation on the Transposition of the Fourth Money Laundering Directive together with draft legislation. A day later, on 16 March 2017, the Treasury published proposals for the reform of the UK's AML supervisory regime including the creation of a new Office for Professional Body Anti-Money Laundering Supervision. On the same day the Financial Conduct Authority ('FCA') published guidance on treatment of Politically Exposed Persons ('PEPs') and on 21 March 2017, the Joint Money Laundering Steering Group ('JMLSG') published proposed changes to its guidance to financial firms to reflect the new draft legislation.

MLRs 2017: Consultation

4MLD is designed to improve EU defences against money laundering and terrorist financing and is the most sweeping AML legislation in Europe in several years. On 25 June 2015 the 4MLD was enacted, with EU Member States required to implement the legislation within two years.

The Directive contains provisions that EU States must enact, but there are a number of areas where States have discretion in implementation. On 15 September 2016 the Treasury launched a consultation on the transposition of the 4MLD. It outlined how the Government intended to implement the Directive and the Fund Transfer Regulation which accompanies it. The Government received 186 responses and this latest publication by the Treasury is a summary of those responses and the Government's policy positions following the consultation.

By and large the Treasury has endorsed a risk based (rather than strict rule based) approach to anti-money laundering controls as well as resisting any temptation to gold-plate legislation. More onus is placed on firms developing their own risk based policies and procedures.

The Government has also published a draft of new money laundering regulations: the MLR 2017, which will replace the Money Laundering Regulations 2007. The Treasury publication also acts as a consultation on those draft regulations, but with responses due by 12 April 2017 and a deadline for the legislation to come into effect by 26 June 2017, the expectation is that this draft is largely in final form.

The policy changes will affect everyone in the regulated sector and the main areas of consultation are set out below.

Who is not covered?

Where there is little risk of money laundering, the Government has the power to grant exemptions from AML controls to those engaging in financial activity on an occasional or limited basis. Following broad support during the consultation, the Government proposes to increase the current turnover threshold to £100,000 to reduce the burden on small businesses.

Due diligence on existing customers

As part of their AML obligations, firms are required to apply customer due diligence ('CDD'), simplified due diligence ('SDD') or enhanced due diligence ('EDD') to their business relationships.

In the case of applying CDD measures to existing customers when their circumstances change, the Treasury believes firms should apply a risk based approach. The Government has decided to include in MLR 2017 a summary of the risk factors that would indicate CDD should be applied to existing customers but is leaving it to sector bodies to provide sector-specific guidance to assist firms.

Application of SDD

The current money laundering regulations provide a list of relationships to which firms could apply SDD. The Government has proposed removing that prescriptive list and instead leaving it to firms to develop their own risk based policy on when SDD can apply. It is expected that this will reduce the number of instances where SDD is permissible. Whilst there were mixed views expressed in the consultation (with some firms favouring retention of the existing list to improve clarity) the Government has decided to include a non-exhaustive list of factors in MLR 2017 in line with a risk based approach. More detailed examples will be provided in sector-specific guidance.

Pooled client accounts

The consultation asked about the risk relating to pooled client accounts (such as those maintained by solicitors).

Image: ByeByeTokyo / E+ / Getty Images

On the one hand pooled client accounts can be considered low risk and merit SDD because the funds are already overseen by regulated sectors. However, some respondents highlighted that risks were as high or low as the quality of the firm and that pooled client accounts could potentially be exploited for money laundering. The Government view is that pooled accounts should not automatically be eligible for SDD, but again, assessed on a risk based approach.

Third party reliance

Firms may, in certain circumstances, rely on third parties to meet their CDD requirements. There has been a significant expansion of the third parties that can be relied upon, with the proposed regulations now allowing reliance on the entire regulated sector captured under these regulations. However, reliance is rarely used in the UK, since ultimate responsibility always remains with the firm. Another barrier to relying on a third party is that third parties can be slow in providing copies of identification documentation to help identify the customer or its beneficial owner. Following feedback, the Government is proposing to require firms to provide identification documents within two working days.

Electronic money

There is frequently a difference of opinion expressed by some in the EU and those in industry about the money laundering risks presented by electronic money and prepaid cards. On a number of occasions, the EU has expressed concerns that electronic money presents unacceptable money laundering risks and therefore it is no surprise that the 4MLD limits the circumstances in which e-money issuers can be exempted from CDD to the following circumstances:

- the payment instrument is not reloadable, or has a maximum monthly payment transaction limit of €250, and can be used only in that Member State;
- the maximum amount stored electronically does not exceed €250;
- the payment instrument is used exclusively to purchase goods or services; and
- the issuer carries out sufficient monitoring of the transaction or business relationship to enable the detection of unusual or suspicious transactions.

For the purposes of the second bullet point, this may be increased to a maximum of €500 for payment instruments that can be used only in that Member State. Fortunately, the Treasury agrees with the industry that the limits set out under the Directive are sufficiently high to mitigate the money laundering and terrorist financing risk and that the permissible exemptions should therefore be applied (including the implementation of the €500 threshold for payment instruments that can only be used in the UK). Where firms are not exempt from CDD, there was strong support in the consultation for allowing firms to apply SDD on a risk-based approach. The Government agrees and more detailed sectoral guidance will set out the risk-based circumstances in which SDD could apply.

Correspondent banking

Many FinTech firms and challenger banks are heavily reliant on services provided by other banks such as correspondent banking services. The Financial Action Task Force ('FATF') considers that correspondent banking is inherently high-risk and under existing legislation for non-EEA correspondent banking, firms must apply EDD. This requirement contained in existing legislation is carried through to 4MLD. However, as firms establish new and innovative services, it becomes less clear as to what precisely is a 'correspondent relationship' and which products and services are in scope, including for bank-to-bank or principal-to-principal transactions that do not relate to an underlying customer of the respondent institution. The Treasury will work with sectoral guidance drafters to ensure that these issues are considered, and that the definition and requirements around correspondent relationships are clarified. Where a respondent is based in another EEA country, EDD is not automatically required unless that relationship is considered high-risk.

Politically exposed persons

4MLD extends the obligation to apply EDD to all PEPs, their families and associates wherever they are located (previously there was an exemption for domestic PEPs). However, following concerns expressed by UK politicians

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about the onerous application of EDD to low risk PEPs and their families by some banks, the Government has taken steps to require the FCA to publish guidance ensuring that EDD is applied on a risk sensitive basis. The FCA's consultation on draft guidance was issued on 16 March 2017. Low risk PEPs (such as most UK MPs) should be subject to a lower standard of EDD.

However, it is important to note that the guidance still does not entitle firms to treat low risk PEPs in the same way that they would a standard customer. Whilst an average UK MP will be treated as a low risk PEP, the money laundering risk is still regarded as being higher than for a standard retail customer. Accordingly the MLR 2017 still requires firms to establish source of wealth and source of funds for PEPs and their families, obtain senior management approval for the business relationship and conduct enhanced ongoing monitoring. This means that whilst firms may be able to automate some aspects of due diligence for PEPs, some manual processing will still be necessary. Nevertheless, as the guidance makes clear, in most cases where an existing customer becomes a domestic PEP, the bank ought to be able to conduct enhanced due diligence from both its own and public records without the need to trouble the customer.

Allied to concerns about over burdensome inquiries are those relating to 'de-risking.' In practice this means firms choosing not to do business with certain types of customer (such as PEPs) rather than devote the additional resource necessary to conduct EDD. Whilst in theory firms can of course choose who they do business with, the FCA has nevertheless made clear that in its view there should be relatively few cases where it is necessary to decline business relationships solely because of anti-money laundering requirements. FATF, the EU and HM Treasury have all made clear that refusing to take on a customer simply on the basis that they are a PEP is contrary to both the letter and the spirit of the law. This presents challenges for challenger banks, FinTechs and other start-ups, whose automated systems or app-based platforms may be ill-suited to the bespoke challenges presented by PEPs. Nevertheless, as this guidance makes clear they cannot choose to avoid doing business with such customers solely on the basis of their PEP status.

Firms will need to ensure that their treatment of PEPs is in line with FCA guidance (or be able to objectively justify why the treatment departs from the guidance). In many cases this may mean fine-tuning a firm's risk assessment methodology for PEPs and in other cases might mean adjusting their due diligence procedures, for example to enable them to conduct source of wealth and source of funds checks on low risk PEPs without the need to make further inquiries of customers.

Beneficial ownership - the 'fit and proper' tests

Article 47 of 4MLD requires that managers and beneficial owners of Money Services Businesses ('MSB') or Trust or Company Service Providers be fit and proper persons. The Government has sought views on the scope of the fit and proper test in the MSB sector. The sector operates through a network of more than 50,000 agents, many of whom have relationships with more than one MSB. The new regulations provide that fit and proper tests are to be carried out on both the MSB principal and agent by HMRC. The Treasury believes that this will bring uniformity in fit and proper tests across the sector. In addition the FCA will be given power to refuse the registration of 'Annex 1 financial institutions' (such as non-bank providers of safe deposit boxes, firms offering finance leases and commercial lenders) where the FCA does not consider management to be fit and proper.

Anti-money laundering supervisory regime

The UK's supervisory regime is unique in respect of the number and diversity of bodies that supervise businesses for AML/CFT purposes. These range from statutory regulators to professional bodies, and the system has grown up organically over the years. There are currently 27 bodies appointed by Treasury as AML/CFT supervisors. This may provide advantages, allowing supervisors to leverage their specialist knowledge of their sectors in order to more effectively manage the risk of financial crime. However, there can be an overlap in the sectors covered by supervisors.

Following the consultation, the Treasury has concluded that there are strong advantages of retaining the range of AML supervisors in helping ensure that a diverse range of innovative products are fully understood. However, to help deal with inconsistencies in the supervisory approach and overlaps between professional regulators, the Government intends to create a new Office for Professional Body AML Supervision which will be hosted by the FCA. This body will largely focus its work on the accountancy and legal sectors, where multiple professional bodies work together to provide AML supervision. It will provide a centre of expertise and, once in place, will help inform Government's analysis of the AML regime, including future National Risk Assessments.

The introduction of this new 'super-supervisor' is unlikely to have a direct impact on organisations in regulated sectors, since it will largely deal with the supervisors themselves; however, as pressure is put on some supervisors to raise their game, organisations in sectors that have arguably enjoyed light-touch regulation may face increased scrutiny.

Summary

Firms affected by MLR 2017 (which means most authorised firms) need to work towards being compliant with the new regulations and guidance by 26 June 2017. Firms have been aware of the terms of the Directive since 2015 and accordingly any changes required by these latest publications should amount to fine tuning only. Given the priority given to financial crime and anti-money laundering by the FCA and Treasury, firms need to be able to demonstrate that they can hit the ground running when MLR 2017 comes into effect.