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THIRD MONEY LAUNDERING DIRECTIVE

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Overview

The Money Laundering Regulations 2007 (“the Regulations”), which incorporate requirements introduced by the European Union’s Third Money Laundering Directive, came into effect on 15 December 2007. This note addresses the key changes introduced by the Regulations.

Scope

The Regulations **extended the scope of the sectors** covered by the anti-money laundering regime in the UK and as a result the Regulations now apply to the following sectors:

1. credit institutions;
2. financial institutions;
3. auditors, insolvency practitioners, external accountants and tax advisers;
4. independent legal professionals;
5. trust or company service providers;
6. estate agents;
7. high value dealers;
8. casinos.

The Regulations also introduced obligations on branches and/or subsidiaries of a credit or financial institution which are located in a non-EEA state to apply, to the extent permitted by the law of that state, measures at least equivalent to those set out in the Regulations. If the law of the non-EEA state does not permit the application of such equivalent measures by the branch or subsidiary undertaking located in that state, the credit or financial institution must inform the FSA accordingly and take additional measures to handle the risk of money laundering and terrorist financing.

Key Concepts

A key change made in the Regulations is the re-definition of **business relationship** which is a critical element in determining whether the due diligence measures, as referred to in Regulation 7, are triggered. Under the new definition a **business relationship** means *a business, professional or commercial relationship between a relevant person and a customer, which is expected by the relevant person when contact is first made between them to have an element of duration.*

Under the Regulations the obligation to undertake **customer due diligence measures** applies not only to **business relationships** but also to **occasional transactions**. These are defined as *transactions (carried out other than as part of a business relationship) amounting to 15,000 euro or more, whether the transaction is carried out in a single operation or several operations which appear to be linked.*

Customer due diligence measures are themselves defined in the Regulations as follows:

- a identifying the customer and verifying the customer's identity on the basis of documents, data or information obtained from a reliable and independent source;*
- b identifying, where there is a beneficial owner who is not the customer, the beneficial owner and taking adequate measures, on a risk-sensitive basis, to verify his identity so that the relevant person is satisfied that he knows who the beneficial owner is, including in the case of a legal person, trust or similar legal arrangement; and*
- c obtaining information on the purpose and intended nature of the business relationship.*

a and b above were reflected in the previous requirements and so it is in relation to c that firms may have needed to enhance their procedures.

Risk based approach

The Regulations provide a statutory basis for the **risk based approach** to money laundering which was introduced in September 2006 by the Joint Money Laundering Steering Group ("JMLSG"). The Regulations place an obligation on firms to adopt a risk-based approach both to customer due diligence and on-going monitoring of business relationships. This is beneficial to firms as it enables flexibility in the approach used to meet their due diligence obligations.

The Regulations set out specific circumstances where **enhanced due diligence measures** are required and the circumstances in which **simplified due diligence** is permitted.

Enhanced due diligence measures are required in the following circumstances:

- where the customer has not been physically present for identification purposes;
- where a credit institution has or proposes to have a correspondent banking relationship with a respondent institution from a non-EEA state;
- where a relevant person proposes to have a business relationship or carry out an occasional transaction with a **Politically Exposed Person** (see below); or
- any other situation which by its nature can present a higher risk of money laundering or terrorist financing.

Politically Exposed Persons (PEPs)

The issue of PEPs relates to customers and beneficial owners who hold, or have recently held, public office. The perceived risk is that of corruption, abuse of public funds, corrupt payments and kickbacks on contracts awarded. The Regulations introduce a definition of Politically Exposed Persons which includes individuals (together with immediate family members and known close associates) who are or have been, within the last 12 months, entrusted with a prominent public function. They include heads of state, heads of government and ministers, members of parliament, high ranking members of the judiciary, members of courts of auditors or boards of central banks, high ranking members of the armed forces, ambassadors and charges d'affaires.

There is a presumption of suspicion in relation to PEPs and accordingly the Regulations require that firms have in place enhanced due diligence procedures when entering into a business relationship or undertaking an occasional transaction with a PEP.

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Simplified due diligence

Regulation 13 sets out circumstances in which **simplified due diligence** is permitted. Under the simplified approach firms are not required to apply customer due diligence measures in circumstances in which they have reasonable grounds for believing that the customer, transaction or product related to such transaction, falls within any of the following:

- a credit or financial institution (in the UK and EEA which is subject to the Directive or, in the case of an institution outside the EEA, if the jurisdiction in question imposes requirements equivalent to those laid down in the Directive);
- a company whose securities are listed on a regulated market which is subject to specified disclosure obligations;
- an independent legal professional and the product is an account into which monies are pooled;
- a public authority in the UK;
- a life insurance contract where the annual premium is no more than 1,000 euro or where a single premium of no more than 2,500 euro is paid, an insurance contract for the purposes of a pension scheme where the contract contains no surrender clause and cannot be used as collateral, a pension, or electronic money.

It is imperative however in instances in which firms undertake simplified due diligence to be able to demonstrate the “reasonable grounds” in relation to which the simplified approach was used. For example, evidence of a client’s listed status should be obtained and recorded.

Timing of Verification

The Regulations introduced **specific timing factors** and state that appropriate verification checks are undertaken *before the establishment of a business relationship*. There is however a degree of flexibility insofar as the Regulations state (in keeping with the risk-based approach) that verification checks *may be completed during the establishment of a business relationship* in certain circumstances. It is important to note however that verification checks should always be undertaken prior to entering into a business relationship with a customer.

If a firm has been unable to complete verification checks within the prescribed timescales the firm must not carry out a transaction with the customer; must not establish a business relationship or carry out an occasional transaction with the customer; must terminate any existing business relationship with the customer; and must consider making a report to the Serious Organised Crime Agency.

Third Party Reliance

The Regulations include provisions relating to **reliance on third parties** including a definition of a third party in a “reliance” context. The definition broadly encompasses any regulated firm, firm of auditors, lawyers, accountants, notaries, tax advisers etc in the UK or EEA which is subject to the Regulations or equivalent local legislation which incorporates the Directive and additionally any similar type of firm subject to requirements equivalent to those laid down in the Directive. (Firms should assess which countries they consider to fall within this category and should record their justification as to why they consider the country to have “equivalent” legislation in place.)

Ongoing monitoring

In addition to the obligations on firms to undertake customer due diligence at the outset of a business relationship, firms are required to conduct ongoing monitoring of every business relationship which means:

- scrutiny of transactions undertaken throughout the course of the relationship (including, where necessary, the source of funds) to ensure that the transactions are consistent with the firm's knowledge of the customer, his business and risk profile; and
- keeping the documents, data or information obtained for the purpose of applying customer due diligence measures up-to-date.

Records

The Regulations maintain record keeping requirements, however these are extended to include records relating to ongoing monitoring as well as the records made at the outset of a business relationship. Firms are required to retain records for a minimum of five years from either the date on which the last transaction is completed or from the date of the cessation of a business relationship with a client.

Summary

Many of the concepts and obligations introduced by the Directive are not new to the UK and have been addressed previously in the JMLSG Guidance Notes. The Directive and Regulations do however put these obligations on a statutory footing and firms should therefore have incorporated all of the new concepts and obligations into their anti-money laundering procedures. Please get in touch with us if you require assistance with this.