

Money Laundering

The monthly briefing service for anti-laundering specialists

bulletin

Getting out of Europe – the “equivalence” question

*The practical (and in some respects intended) effect of the Third Directive and the Money Laundering Regulations 2007 is to make it much more difficult for regulated firms to do business outside the EU, and vice versa, says **David McCluskey** of Peters and Peters. The response to the charge that the Third Directive is simply an expensive trade barrier is the concept of “equivalence”, a word which first appears in the Third Directive, and is transposed into the UK Money Laundering Regulations, though in neither document is there a definition. The EU Committee on the Prevention of Money Laundering and Terrorist Financing may finally have arrived at a list of third countries, which the EU regulated sector is able to regard as equivalent [1] but it is far from a panacea.*

“Equivalence” should allow non-EU member states and institutions access to EU-regulated services under the gateways of Simplified Due Diligence (SDD) [2] (for certain categories of customer) and/or Reliance [3] (for introductions by certain categories of person). Regulation 13 contains two such gateways and a third indirect one.

Equivalence and Simplified Due Diligence [4]

In short, a relevant person is not required to apply customer due diligence (CDD) measures where the customer is a credit or financial institution (or “equivalent” institution) situated in a non-EEA state, which imposes requirements equivalent to those laid down in the Money Laundering Directive and is supervised for compliance with those requirements. CDD is equally not required where the customer is a company whose securities are listed on a “regulated market subject to specified disclosure obligations.” The phrase “regulated market” has a specific meaning within the EEA but outside the EEA means the following: “A regulated financial market which subjects companies whose securities are admitted to trading to disclosure obligations which are contained in

international standards and are equivalent to the specified disclosure obligations.” [5]

“Specified disclosure obligations” are then further defined to mean disclosure requirements consistent with a number of Directives and community legislation dealing with insider dealing, market manipulation, prospectuses, public offerings and harmonisation of transparency requirements. [6]

You will have already noted that there appear to be two kinds of equivalence at work here; the first, equivalence with the Third Directive and the second, equivalence to (or indeed consistency with) “international standards”. Insofar as the concept of a regulated market is concerned, this is explicable if one considers that the Third Money Laundering Directive does not deal with disclosure standards for the regulated markets and thus reference is required to international or community standards. Nonetheless those international standards must be “equivalent” to the relevant EU directives and law as set out above.

However, this second requirement does not appear in the third, indirect gateway to Regulation 13 at Regulation 13(4). This excuses a relevant person from carrying out CDD where the customer is an independent legal professional and the product is an account into which monies are pooled provided that (where the account is held in a non-EEA state) the non-EEA state imposes requirements to combat money laundering and terrorist financing which are “consistent with international standards”. The professional must be supervised in that state for compliance with those requirements and information on the identity of the persons on whose behalf monies are held in the pooled account is available to the institution which acts as a depository institution for the account.

Should it be assumed that by the very specific use of the phrase “consistent with international standards” as opposed to “equivalent to the Money Laundering

Directive” it was intended that a different standard should apply to non-EEA territories holding pooled accounts? Such a conclusion is illogical in the context of money laundering compliance and no one would argue that by “international standards” a lower threshold than the Third Directive was meant to apply to this part. However, if “international standards” really was a concept interchangeable with “EEA equivalent”, there would be no need for money laundering regulations, much less a concept of equivalence. [7] Presumably a person applying this section will simply read in the words “equivalent to the Third Directive” – or will he?

Equivalence and Reliance

In broadly similar fashion, CDD carried out by others may be “relied on” by a relevant person in certain circumstances. Those others include certain non-EEA entities and professionals who are subject to mandatory professional registration recognised by law, and

- “subject to requirements equivalent to those laid down in the Money Laundering Directive; and
- are supervised for compliance with those requirements in a manner equivalent to section 2 of Chapter V of the Money Laundering Directive.”

The concept of reliance has been significantly upgraded in the 2007 Regulations compared to previous incarnations, and for those businesses that are able to make use of it, Regulation 17 represents a significant cost saving tool. Firms doing repeat business with clients or obtaining repeat referrals from intermediaries will wish to use the Regulation whenever possible. Given the potential risk it is no surprise that a relevant person’s ability to rely on CDD carried out by another within the EEA is strictly circumscribed. [8] Most importantly, who can be relied on is strictly defined. A “reliable” person must be a credit or financial institution which is an authorised person, or a relevant person who is an auditor, insolvency practitioner, external accountant, tax adviser or independent legal professional. Not just any accountant, tax adviser or legal professional can be relied on: only those with certain letters appearing after their name, such as ACCA, ICAEW, [9] etc.

No such fine distinctions are made as to which non-EEA professional bodies’ members may or may not be relied on for purposes of Regulation 17: the only filter is that they be subject to “equivalent” requirements. One could well understand the explanations of a Treasury official about the Sisyphean task of

identifying, listing and assessing myriad overseas professional bodies; the fact remains that the current law arguably discriminates against the “Part 2” [10] UK professional bodies who are unlucky enough to find themselves listed as, effectively, “not reliable”; and discriminates in favour of members of those “Part 1” UK bodies (who can be relied on) and overseas professional bodies whose jurisdictions are able to find their way, as we shall see below, onto the EU’s non-binding list of equivalent jurisdictions. The difference is more than theoretical: Part 2 UK professionals will be less competitive through not being able to have their CDD relied on by others, but bear no less a burden of compliance in relation to the Money Laundering Regulations and the Third Directive than Part 1 professionals, and arguably a greater burden than non-EU professionals from “equivalent” jurisdictions.

Equivalent standards at non-EEA branches

Credit or financial institutions must require their non-EEA branches and subsidiaries to apply CDD, ongoing monitoring and record-keeping measures “at least equivalent” to those in the Regulations, “to the extent permitted by the law of that state”. [11] In other words, we must export our law whenever we can. This ‘whenever possible’ standard for CDD, ongoing monitoring and record-keeping in overseas branches may clash with the unqualified “equivalent” requirements mentioned above. As an example, the substantive anti-money laundering law in the Cayman Islands [12] has a very similar structure to UK law, except that entities who make a suspicious transaction report to the territory’s FIU (The Financial Reporting Authority) need not seek consent before doing what would in the UK be a prohibited transaction. [13]

Nonetheless compliance with Regulation 15 in respect of the Caymans would not be a particular problem, because the “branch equivalence” requirement only applies to CDD, ongoing monitoring and record keeping. Thus provided these were carried out to the UK standard, the institution would not have to inform its supervisory authority and take “additional measures” to handle the AML risk. [14] But further than this maintaining UK standards for these three areas would be of no practical use at all if another branch (or any EU regulated person for that matter) was not able to deal with the Cayman branch via the simplified due diligence or reliance gateways. [15]

So who is equivalent?

Article 11(4) of the Third Directive states that member

states shall inform each other and the Commission “of cases where they consider that a third country meets the conditions [of equivalence to the Third Directive]”. The response to this has been a series of meetings at European level to try to agree a list of jurisdictions deemed equivalent; as mentioned above, it finally succeeded in April this year. [1]

The first Money Laundering Directive [16] grew out of the (then forty) recommendations of FATF, and of course that organisation continues to monitor EU and non-EU countries for compliance with international AML standards. [17] It is something of a missed opportunity that regulated institutions are now burdened with yet another layer of compliance, yet another list, instead of beginning with what does or does not pass the stringent standards of FATF. [18] For if a country is viewed benignly by FATF, then calling it an “equivalent jurisdiction” under the Directive is surely to call a rose a *rugosa magnifica*.

Except of course, that no jurisdiction, not even within the EU, is rated as fully compliant by FATF. According to a recent report [19] even the most fully compliant countries have had their efforts to implement FATF’s 40 recommendations marked as “PC” (Partially Compliant) [20], and several, including Norway, Portugal and the UK, have at least one “NC” (Non-Compliant) assessment. The article continues: “These results imply that there are a lot of holes in the financial framework through which a money launderer could operate, even with FATF members. This is not an acceptable situation given that FATF members would be expected to have the best AML systems in the global financial network”. [21]

We may therefore end up with a different problem. Irrespective of the composition of the list or lists (see below), every self-respecting compliance officer viewing an application for business from the newly minted “equivalent” jurisdiction will nonetheless be mindful of FATF’s much more thorough (and most likely more grudging) view (if there is one) of that country’s anti-money laundering legislation. This is relevant because the simplified due diligence and reliance gateways are subject to the ‘hair trigger’ of Regulation 14(1), which imposes enhanced due diligence “in any other situation which by its nature can present a higher risk of money laundering or terrorist financing.”

Does a “Partially Compliant” or “Non-Compliant” rating by FATF in respect of one of its recommendations constitute such a situation? By definition that must be so, otherwise there would be

no need for the rating. But follow it to its logical conclusion and in a stroke the “equivalence” gateway is rendered meaningless. To take an extreme example, surely no one would argue that enhanced due diligence must be conducted on all American customers because the USA is deemed partially compliant in respect of two of the FATF Forty recommendations and non-compliant in respect of four? [22] The gap between the law and reality is ever widening.

The ‘hair trigger’ problem is underlined by the fact that the EU list is not binding – and EU member countries will probably resort to creating their own lists. [23] Others have noted [24] that there is discussion over allowing EU countries to designate different countries as equivalent or non-equivalent according to their own views. As pointed out in that article, this could lead to regulatory arbitrage with companies regulating their business so as to go through EU countries who consider the source country to be equivalent.

Worse, a proliferation of (and inconsistency between) equivalence lists will turn the gateway into a Kafkaesque compliance nightmare for EU multinationals. There is real danger that a well-meaning attempt to reduce the compliance burden where risk is lowest may end up rendering the equivalence gateway meaningless. After all, a non-binding list of equivalent jurisdictions really just means “Use at Your Own Risk”.

Notes

1. The list comprises: Argentina, Australia, Brazil, Canada, Hong Kong, Japan, Mexico, New Zealand, the Russian Federation, Singapore, Switzerland, South Africa, and the United States. The following text forms a footnote to the Common Understanding: “The list does not apply to Member States of the EU/EEA which benefit *de jure* from mutual recognition through the implementation of the 3rd AML Directive. The list also includes the French overseas territories (Mayotte, New Caledonia, French Polynesia, Saint Pierre and Miquelon and Wallis and Futuna) and the Dutch overseas territories (Netherlands Antilles and Aruba). Those overseas territories are not member of the EU/EEA but are part of the membership of France and the Kingdom of the Netherlands of the FATF. The UK Crown Dependencies (Jersey, Guernsey, Isle of Man) may also be considered as equivalent by Member States.” Gibraltar is likewise to be regarded as equivalent.

2. Regulation 13
3. Regulation 17
4. Regulation 13
5. Part (b) of the definition of “Regulated Market” at Regulation 2.
6. See the definitions at Regulation 2. The relevant Directives are 2003/6/EC, 2003/71/EC, and 2004/109/EC.
7. Article 11(b) of the Third Directive is the genesis of the phrase “consistent with international standards” in this section.
8. A person being relied on must first consent (Regulation 17 (1) (a)), and responsibility for failures of CDD remains with the relevant person. The person being relied on must also agree to retain records in compliance with Regulation 19 (6).
9. Regulation 17(2)(b)(ii) and Schedule 3 Part 1. By definition members of those bodies listed in part 2 cannot be relied on for the purposes of Regulation 17.
10. Ibid.
11. Regulation 15(4)
12. *Proceeds of Criminal Conduct Law*.
13. The reporter obtains immunity by the making of the report and the authorities instead have the power to unilaterally freeze accounts for up to 21 days.
14. R15(2)
15. The JMLSG Guidelines at 5.6.26 (“Group Introductions”) state that where a customer has been introduced by one part of a financial sector group to another, it is not necessary for his identity to be re-verified, provided that the CDD is to a UK, EU or equivalent standard and the group that carried out the CDD can be relied on under Regulation 17(2). No Caribbean jurisdiction features on the equivalent list, which suggests that CDD will have to be repeated for customers of a group from the Cayman Islands who wish to do business in the EEA other than in the UK.
16. 91/308/EC of 10 June 1991.
17. Mutual evaluations are conducted of the 34 FATF members, while the NCCT programme monitors other potential high-risk jurisdictions.
18. Regulation 18 already provides that the Treasury may effectively ban transactions with non-EEA persons and entities where FATF has decided to apply countermeasures to that jurisdiction.
19. See Jackie Johnson, “Third round FATF mutual evaluations indicate declining compliance”, *Journal of Money Laundering Control* 47 generally and at page 4.
20. Compliance with each recommendation is rated “NC” (Non-Compliant), “PC” (Partially Compliant), “LC” (Largely Compliant) or “C” (fully compliant). On recent assessments only Belgium has no “NC” ratings, though it has five “PC”. Ibid.
21. Ibid.
22. Johnson, *ibid* at 3.
23. At the Committee meetings the Commission has made clear that “it has no power to create a legally binding positive list of equivalent third countries and that it could only act as an honest broker when striving for the creation of a common European list.” Summary records 4 October and 6 December 2006.
24. See *MLB Issue* 151 March 2008, “After policy, practice”.

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